Lucas Papademos: Five years of the euro - past achievements and future challenges

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the conference "The Euro at Five" organised by the Federal Reserve Bank of San Francisco, the European Commission and the University of California at Berkeley, San Francisco, 27 April 2004.

* * *

Introduction

This conference to mark the first five years of the euro, which the Federal Reserve Bank of San Francisco, the European Commission and the University of California at Berkeley have kindly organised together, is - to my mind - akin to a birthday celebration. And as it is always nice to be invited to birthday parties, I am grateful to have the opportunity to address all of you who have shown by your presence here that you take an interest in the development and potential of our new currency - the euro. On such occasions, we often sit back and recall with fondness and pride the past; and for the younger ones, we tend to go back to the joyful day of birth, the delightful but sometimes stressful early years, and we remember the excitement, the achievements, as well as the difficulties associated with growing up. And we do not only talk about the past, we also look forward and talk about what lies ahead: the promising prospects as well as the challenges that may come. This is what I would like to do today for the euro.

The euro: from the drawing board to reality

One cannot understand the genesis and significance of the single currency without going back to the roots of the European construction, and the desire of European nations to create conditions for lasting peace and prosperity on their continent after the two devastating wars during the first half of the 20th century. In designing the post-war framework for cooperation in Europe, the "founding fathers" of what is today the European Union took a truly revolutionary step: they managed to "think outside the box" of autonomous nation states and indivisible sovereignty. They fashioned a novel political organisation, where decisions are made together and sovereignty is shared, and where supranational institutions assume responsibility for the common interest.

Initially, the prime focus of intra-European politics was on how to facilitate the free flow of goods, services, capital and people across national frontiers. Creating a genuine common market in Europe, comparable to the unified market of the United States' economy, was the stated objective. Monetary and exchange rate stability, though not explicitly stipulated in the founding treaties, also became an integral component of this endeavour. Achieving both macroeconomic stability and market integration was not an easy task, as exemplified by the sometimes turbulent history of the European Monetary System, which was established in 1979. Robert Mundell, the Nobel prize-winning economist, offered a theoretical explanation for this phenomenon, suggesting that stable exchange rates, free capital movements and the pursuit of an autonomous monetary policy are, in fact, mutually incompatible objectives for economically highly interdependent countries. It was the European Union which devised and sought to implement an innovative solution to the problem of the "inconsistent trinity". The answer was not to try to just irrevocably fix exchange rates between European currencies, but to do away with their exchange rates altogether, and create "one money" for "one market". In the early 1980s the thinking about a single European currency gained momentum.

The Delors Report of 1989, which laid out the blueprint for the establishment of Economic and Monetary Union, and the Maastricht Treaty of 1992, which provided the legal framework, clearly defined the economic conditions and the institutional framework which had to be established to ensure that the birth of the single currency would take place in favourable circumstances and that the euro would be a stable currency, as strong as the national currencies it would replace. It was stipulated that there was to be a single monetary policy, geared towards the overriding objective of price stability, in the hands of a new, supranational central bank with a federal set-up, which was to be independent from political interference. In addition, countries willing to join the Monetary Union would have to attain a high degree of nominal convergence towards price stability, which would be measured and assessed in terms of low and converging inflation rates, prudent public finances, low long-term interest rates and stable exchange rates. By explicitly specifying in the Treaty 1 January 1999 as the definite target date for the introduction of the euro and by laying out a structured three-stage process for achieving that goal, the member countries of the EU unequivocally committed themselves as early as 1992 to actually making Economic and Monetary Union happen.

Establishing the necessary conditions for the creation of a single currency represented a big challenge for European governments. It required a high degree of nominal convergence towards price stability. This, in turn, required breaking with entrenched habits of fiscal profligacy, reducing budget deficits and high levels of public debt, giving central banks independence to pursue stability-oriented monetary policies, and persuading markets and, more generally, all economic agents to adjust their expectations and behaviour towards attaining convergence to stability. To many sceptical economists, policy-makers and European citizens, this venture looked like a "mission impossible". But if we look back today on the years leading up to 1999, one cannot but be amazed and impressed by the remarkable turnaround in economic policies in Europe during that period, spurred on by the political will and public support (in most countries) to undertake the necessary adjustments to establish Economic and Monetary Union and qualify for participation in it.

If the sceptics were confounded by the governments' determination and ability to meet the convergence criteria, they were equally wrong-footed with their predictions of chaos and havoc in financial markets upon the actual birth of the euro. Thanks to the diligent technical and practical preparations of the European Central Bank and its forerunner, the European Monetary Institute, together with the national central banks of the euro area, and of the financial institutions at large, the introduction of the euro in book-entry form on 1 January 1999 went remarkably smoothly. When trading in the new currency started after the "changeover weekend" on 4 January, very few hitches were recorded. Almost overnight, the national money markets in separate currencies integrated into a single one in euro, also thanks to the pan-European payment system put into place and operated by the Eurosystem.

The first five years: goals, expectations and achievements

As of 1 January 1999, the ECB assumed responsibility for the new currency and the conduct of the single monetary policy. The goal was to ensure that the euro would be a stable currency, and trusted by the European public. The ECB's stability-oriented monetary policy would have to be conducted effectively and to establish its credibility with the markets and with the public at large. Five years on, it is pertinent to ask a few probing questions: How did we do our job as responsible guardians of the new currency? What went well, and where could things have gone better?

Let the facts speak for themselves. During the first five years following the introduction of the euro, the average rate of inflation in the euro area was precisely 2%, in line with the ECB's definition of price stability. Inflation has occasionally risen above the ceiling of 2% owing to a number of adverse price shocks and the ECB's measured response to these shocks, consistent with the medium-term orientation of its strategy. Nevertheless, throughout this five-year period inflation expectations remained firmly anchored to a rate close to or less than 2%, as can be inferred from the yields of index-linked long-term bonds. This fact demonstrates the credibility of the ECB's monetary policy.

The establishment over the past five years of the stability of the internal value of the euro and of the credibility of the single monetary policy was a major achievement. This was not a straightforward task for a new central bank without a track record which operates in a heterogeneous economic area where the responsibility for the conduct of economic policy lies with the national authorities. The environment of price stability and historically low levels of long-term interest rates have also established favourable conditions for economic growth. These conditions, however, have not proved sufficient to support a high rate of growth given the constraining influence of other non-monetary factors.

A second important achievement was the introduction of the euro in physical form. Since January 2002, over 300 million European citizens hold the euro in their hands, in the form of some 15 billion banknotes and 50 billion coins. The logistics of this "cash changeover" represented an operation of unprecedented magnitude and complexity, involving, from day one, not only central banks and financial institutions but all firms - large and small - and the public at large. The smoothness with which the euro banknotes and coins were introduced - and accepted by European citizens - confounded, once more, the sceptics with their scenarios of chaos at the checkout counters, of numerous assaults on cash transports and the like. With the euro banknotes and coins, the citizens of Europe do not only possess a truly tangible symbol of European unity; they also have concrete proof of the irreversibility of the move towards Monetary Union. The euro is here - and it is here to stay!

Of course, giving up the habit of counting in francs, Deutsche Mark or lire and getting used to the new currency was a challenge, both for consumers and producers. And the cash changeover did have some effect on prices associated with their conversion from national denominations into euro. Our statistics show that the introduction of euro banknotes and coins had a rather small one-off impact on inflation, of around 0.3 to 0.4% on average across the euro area. Nevertheless, the citizens of some euro area countries did - unfortunately - experience some disproportionate price increases following the changeover, especially in some sectors of the service industry, and this created the perception that inflation was higher than the rate actually recorded. These perceptions have persisted for a fairly long period of time. The gap, however, between perceived inflation and actual inflation has gradually declined.

As you can see, I do not wish to deny that we also experienced some difficulties, or “growing pains”, with our new currency. For example, communicating our monetary policy in a multilingual, multinational environment has been a real challenge which has set us all - the Eurosystem at the sending end, and the markets and the public at the receiving end - on a steep learning curve. It also took some time for the markets to fully understand our monetary policy strategy, that is, the conceptual framework on the basis of which the Governing Council assesses the economic outlook and the risks to price stability, takes decisions about the appropriate monetary policy stance, and explains these decisions to the markets and the public. By now, the understanding of our strategy has greatly improved, and the recent evaluation and clarification of the strategy has certainly helped to this end.

Although the internal value of the euro, that is, its purchasing power for the European citizens, has remained strong, the evolution of its external value has, at times, been the subject of debate. After a protracted period of depreciation, especially against the US dollar, in 1999-2001, the exchange rate of the euro became the focus of attention in 2003 and early 2004, this time because of its rapid appreciation. All this attention somehow ignores the fact that the euro area economy, like that of the United States, is relatively closed, with the average of exports and imports corresponding to 18.7% of euro area GDP, compared with 11.3% for the United States. Moreover, the macroeconomic implications of exchange rate developments vis-à-vis third currencies are more muted now than prior to the introduction of the euro, because they are no longer associated with fluctuations in intra-euro area financial relationships.

Five years after the introduction of the euro is also a good time to review some other expectations that were formed before the euro came into being, notably expectations about its impact on financial markets and its international role, and to see to what extent these proved to be correct. For example, many academics, financial market analysts and policy-makers had predicted a rapid integration of European financial markets once the single currency eliminated exchange rate risk and reduced transactions costs. Indeed, borrowing costs in euro have been significantly reduced by the emergence of deeper, broader and more liquid continent-wide markets, which have reduced liquidity risk premia, improved access to external finance and lowered financing costs. Moreover, the establishment of the low inflation environment in the euro area and the credibility of the ECB’s monetary policy have reduced inflation risk premia, and interest rates have remained lower and more stable across the maturity spectrum than would otherwise have been the case. If, however, we take the deep, liquid and unified US market as a benchmark, we clearly still have some way to go: the integration of equity markets is at a very early stage, common legal and regulatory frameworks are only gradually being elaborated, and the consolidation of the banking sector is far from complete. While many of these processes are market-driven, EU policy-makers should make efforts to spur on further financial integration, to the benefit of all - individual savers, institutional investors or corporate borrowers, in the euro area and worldwide.

Another area where the expectations, at least of some, diverged from the outcome was the international role of the euro. Before the birth of the euro, some policy-makers and economists had predicted that the euro would quickly develop into an international currency that would rival the US dollar. And indeed, within five years, the euro has become a genuine, fully-fledged international currency; it is now the second-most widely used currency worldwide, and its international role exceeds that of its legacy currencies. For example, in 2003 some 39% of all international bond issues were in euro, compared with 45% in US dollars. In more than 50 countries - mostly in eastern Europe, the Middle East, the Mediterranean and Africa - the euro plays a role as an anchor for exchange rate policies. That said, the internationalisation of a currency is, of course, a long and gradual process, given financial market inertia and network externalities. In international commodity markets, for example, the euro has made few inroads; and there has been a slow shift in the currency composition of official reserves. In our view, the internationalisation of the euro is a market-driven process; the euro will gain its place in global markets on its own merits, by being a stable and trusted currency. The ECB's policy therefore is to neither actively promote, nor hinder, the international use of the euro.

The record of achievements during the first five years of the single currency is, I would say, more than respectable, and, in many regards, beyond expectations. In fact, the euro is already a prize-winner, having been awarded the renowned International Charlemagne Prize of Aachen in 2002 for its contribution to European unification. More fundamentally, it has earned the trust of the European public and the markets as a stable currency which maintains its purchasing power. But that does not mean that we can rest on our laurels. A number of important challenges lie ahead for European policy-makers which also relate to the euro. I would like to concentrate on two of them: first, we need to attain higher sustainable growth in Europe while maintaining price stability; and second, we have to make the enlargement of the EU and, later on, of the euro area a success.

Attaining faster growth with stability in Europe

The euro - or more precisely, the single monetary policy - has delivered an environment of price stability for Europe, and yet the growth performance of the euro area over the past five years has been far from stellar: since the mid-1990s, euro area growth has lagged behind that of the United States, on average by almost one and a half percentage points. How can we explain this gap? And what can be done to close it in the coming years?

The answers to these questions essentially relate to problems and policies concerning the supply side of the European economy. Generally speaking, the divergent growth performances in the United States and Europe can be explained by different productivity performances and different demographic or labour market developments. Although we should be aware of the statistical or methodological problems related to cross-country comparisons, productivity growth in the United States has clearly outstripped that of the euro area. The difference, however, in productivity growth rates between the United States and the euro area is much smaller when productivity is measured per hour worked rather than per person employed. This is due to differences in hours worked per person, which have been broadly stable in the United States, while they have been declining in the euro area. The decline in average hours worked in the euro area over recent years reflects both a tendency towards a shorter working week and more part-time employment.

Some economists have argued that these developments are largely due to different preferences for work and leisure, which are reflected in a higher labour force participation rate and longer working hours in the United States. In other words, Europeans tend to use productivity increases to buy themselves more leisure, while Americans use them to generate more income. In my view, this argument can only provide a partial explanation. In fact, lower participation rates and shorter working hours in Europe can be ascribed, to a considerable extent, to rigid labour market institutions and the disincentives set by tax and social security systems, which influence the preferences of individuals regarding employment and leisure.

With more flexible labour markets, fewer restrictions and lower taxes on labour, many people would decide to work more than at present. A higher labour force participation rate is - in the absence of population growth comparable to that of the United States - the main lever with which we can also address the mounting problems related to the ageing of the European population. Although some EU countries already have employment rates comparable to the United States, and some others can match the United States in terms of productivity, no single European country manages to do both. By stepping up the pace of structural reform in labour markets, European countries can increase productivity and labour force participation, and thereby raise potential growth substantially.

Structural reforms in labour and product markets in order to make the economy more flexible and productive also yield other benefits, some of which are "closer to home" for me as a central banker. In an economic environment characterised by greater market flexibility, the single monetary policy can maintain price stability and help support economic growth much more effectively. By increasing the speed with which labour and product markets respond to shocks and policies and by raising the long-term rate of sustainable growth, structural reforms to boost productivity and flexibility in the euro area economy enhance the effectiveness of monetary policy to preserve price stability under monetary and financial conditions fostering faster growth. The United States provides a "living example" in this respect: strong productivity growth in the past few years has contributed to raising potential output and alleviating the risk of monetary accommodation during a period of economic recovery leading to the build-up of inflationary pressures.

It should be clear from what I have said that, over the long term, the key to addressing the problem of Europe's less-than-satisfactory growth performance lies with national governments, trade unions and employers, and not with the ECB. Monetary policy cannot be expected to increase economic growth sustainably by tolerating higher inflation. What it can do is to promote long-term growth by maintaining an environment of price stability - and this is precisely what the ECB is committed to doing.

At the present juncture, with the euro area economy operating below capacity, the pace of economic recovery hinges critically on strengthening the confidence of both consumers and producers. The ECB's current monetary policy stance - with interest rates at their lowest level in over 50 years - has been, and continues to be, conducive to the expected pick-up in economic activity.

EU enlargement and the prospect of euro adoption

Let me now turn to another important challenge for the European economy and policy-making, which is related to the forthcoming - indeed imminent - enlargement of the European Union. In just a few days - on 1 May - the largest ever expansion of the EU will take place, when ten countries with a total population of 75 million people join the Union. This is an event of historic significance that will influence the course of European integration in many ways. The performance of the European economy in particular will be affected by the further economic, financial and monetary integration of the new Member States.

Although the upcoming EU expansion is the largest ever in terms of the number of countries, population and geographic area, the associated increase in the level of economic activity and the productive capacity of the EU initially will be relatively small. In fact, the combined GDP of the ten new member countries corresponds to about 5% of the total GDP of the current members of the EU. This will, of course, change over time since the new Member States have the capacity to grow faster, as defined by the major determinants of long-term growth and their "catching-up" process. We should not forget that not so long ago, most of the new entrants, eight out of ten, were centrally planned economies. Over the past decade, they have made impressive progress in their transition to market economies and, on average, they have experienced strong economic growth. Nevertheless, the average per capita income in the acceding countries in terms of purchasing power is still only about half of the EU average. It is therefore clear that achieving real convergence and a catching-up of living standards will continue to be their central objective and policy challenge. This objective must be achieved in parallel with further progress towards macroeconomic stability and the establishment of the necessary conditions for the adoption of the euro.

The enlargement of the European Union will not coincide with an expansion of the euro area. All new Member States, however, are committed to eventually adopting the euro as their currency sometime in the future. They do not have a right, as Denmark and the United Kingdom have, to opt out of the single currency. And, already, most of them have unilaterally announced target dates for joining the euro area. In order to do so, they must fulfil the relevant requirements laid down in the Maastricht Treaty. This means that they must achieve a high degree of sustainable nominal convergence, which will be assessed on the basis of the same criteria that were met by the current members of the euro area. One of these criteria is exchange rate stability, which requires participation of the currency in the exchange rate mechanism (ERM II) without severe tensions for at least two years. These requirements for euro adoption must be fulfilled not only because the principle of equal treatment should be respected. They must be fulfilled for substantive reasons too: that is, in order to ensure the smooth entry and successful participation of a country in the European Monetary Union. We should not forget that a Member State's decision to adopt the euro is irreversible.

It is not possible to identify a unique path towards euro adoption for the new Member States, or to recommend one particular, single strategy as the most appropriate one for achieving this goal. It is also difficult to predict the exact time when prospective participants will join the euro area - although the target dates announced by most of them range from 2007 to 2010. There are several reasons for these conclusions. At present, the economic situations of the new Member States differ considerably, notably with regard to the degree of nominal and real convergence they have achieved. Moreover, these countries are characterised by different economic structures and they employ a variety of monetary policy strategies. Overall, and on average, the progress made towards convergence by the acceding countries is considerable, but it is not uniform in all areas, and there are also significant divergences across countries. Consequently, the economic situations and policy strategies of the new Member States will be assessed on a case-by-case basis as they proceed towards euro adoption.

Despite the progress already made towards macroeconomic stability by the acceding countries overall, achieving the necessary degree of nominal convergence for joining the euro area will require the effective tackling of several policy challenges in a number of countries. Their commitment and determination to adopt the euro sooner rather than later has oriented their macroeconomic policies towards stability. Greater and more systematic efforts are, however, necessary to reduce fiscal deficits, which on average were 5.3% of GDP in 2003, well above the reference value of 3%, and in some countries substantially higher. This is essential both for the fulfilment of the fiscal convergence criteria required for euro adoption and for the achievement of budgetary positions which will allow the automatic stabilisers to work and provide some room for manoeuvre for fiscal policy after joining Monetary Union. Moreover, it is also essential that prospective euro area participants achieve greater convergence of market structures and institutions in the coming years. Although such convergence is not, in general, a prerequisite for euro adoption, it is, in my view, important for the successful performance of their economies within the euro area.

With regard to the conduct of the single monetary policy in an enlarged euro area, several questions have been raised and concerns expressed. Will the adoption of the euro by a number of countries that aim at achieving real convergence affect the orientation and formulation of the single monetary policy? And will the implementation of this policy become more complex in a larger and more heterogeneous Monetary Union? The answer to both of these questions is a simple no. The monetary policy stance of the ECB is determined by its mandate to maintain price stability for the euro area as a whole over the medium term. The enlargement of the euro area cannot - and will not - change the ECB's commitment to achieving its primary objective. And I am convinced that the national central banks that will join the Eurosystem in the future share this view and commitment. Indeed, the experience of acceding countries in recent years confirms the validity of the proposition - which is generally supported by evidence - that there is no permanent and exploitable trade-off between long-term growth and inflation. It is worth noting that average inflation in the new Member States has declined from double-digit rates at the end of the 1990s to 2.1% in 2003, a level comparable to that in the euro area and only marginally above the ECB's definition of price stability. And, of course, all countries that will join the euro area in the future will have attained a high degree of sustainable convergence towards price stability.

That said, it is foreseeable that a future enlargement of the euro area will increase the divergences in inflation and growth rates across the different regions of the single currency zone. However, regional differences in economic performance are an inescapable feature of any large currency area. The existence of regional differences is certainly not news to a US audience. Inflation here in San Francisco is different to that in Dallas or New York. Significant differences in terms of inflation and output levels also exist in the United States, and the Federal Reserve has nonetheless conducted its monetary policy smoothly and successfully. In a sense, the Federal Reserve conducts a "one-size-fits-all" monetary policy just as the ECB does. In the euro area, already today, with only five years' experience of the single monetary policy, we can observe a process of increasing convergence of the economies, be it in terms of the synchronisation of business cycles, aided by converging interest rates at all maturities, or in terms of real GDP levels. Thus, the dynamics of convergence that should be inherent in a monetary union appear to be at work.

Concluding remarks

From my preceding remarks, you rightly get the impression that I am confident about our ability to master the challenges that lie ahead, for our young currency and for the enlarged European Union. Of course, to some of you, who are not so immersed in the internal dynamics of European integration, this may appear to be an expression of unwarranted optimism. After all, we have sometimes heard voices of scepticism about the viability of this unique construction of a "currency without a state". A decade ago, Martin Feldstein claimed that Economic and Monetary Union would create great tensions which could even lead to another war in Europe. Even if the doubts about the effects of the euro no longer lead to such extreme predictions, a certain pessimism nevertheless still exists. Most of it is unfounded. Current criticism often tends to blame the euro for problems which have very little to do with it, such as labour market rigidities, overstretched social security systems, a fiscal system not ready to cope with population ageing and many other things. It is unlikely that these problems would have been solved had the euro not been created. Indeed, the introduction of the euro may be forcing governments to confront structural problems which they had previously ignored. Moreover, the euro has shielded many euro area countries from significant exchange rate volatility and financial market turmoil in the face of the many adverse shocks that have occurred over recent years, including geopolitical tensions.

Today we mark “The Euro at Five”. As I have explained, the accomplishments of those five years are already substantial, and we are ready to face the challenges ahead. Let me therefore conclude my speech at this birthday party by saying that we are looking forward to many, many happy returns.

Thank you very much.