Jean-Claude Trichet: The euro - successes and challenges

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the European American Press Club, Paris, 14 January 2005.

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Introduction

Ladies and gentlemen,

It is a pleasure to be here today to share with you some thoughts on the successes and challenges of the euro. European integration has moved steadily forward over the past decades, witnessing considerable success and triggering fundamental change. The euro, which is probably the most visible and tangible symbol of this integration process, is this year entering its seventh year, with a single currency and a single monetary policy for more than 300 million citizens. All in all, the European Monetary Union has managed very well in not always so easy conditions, despite some critiques, doubts and fears that were voiced earlier on. Of course, the euro also has brought about significant challenges. I would today like to discuss in more detail what I see as the main successes and challenges of the euro. I would also like to reflect on the need to accept change and reform in order to move forward. Let me start with the successes to date.

Successes

The first success I would like to stress is a technical success which enabled a smooth implementation of the single monetary policy from day one, namely the **integration of money markets** in early January 1999. Thanks to careful technical preparations of connecting national payment systems, smooth interbank transactions with small spreads were made possible. Looking at European **financial markets** more in general, while there has been a continued process of integration over the last decades, the arrival of the euro certainly accelerated this process by removing barriers to cross-border trading and creating more scope for risk sharing and diversification. In particular, the depth and breadth of financial markets have increased as a consequence of the elimination of exchange rate risk and the rapid growth of new market segments, such as the corporate bond market, allowing more investors to access the various financial markets in the euro area. This in turn has led to more efficient financial markets which have contributed to economic growth.

Second, **euro cash changeover** stands out as a major milestone in European monetary history. It was also a particularly successful event in terms of logistics. Changing the currency for more than 300 million people in a few weeks was truly daunting. The efficiency and enthusiasm with which this changeover took place was exemplary. This success can be attributed to the quality of the preparations made by all players involved and at all levels, not to mention the enthusiastic reception of the general public. In fact, in all countries, the changeover period was much swifter that anticipated. Sharing a single currency implies a need of a feeling of community and trust among all the users of the currency. After all, a currency is backed by the mutual trust placed in it by its users. The relative ease with which euro cash was introduced and accepted by people shows that there may be stronger feelings of community in Europe than many would have thought.

Third, another important, but sometimes grossly underestimated success of the euro relates to the **convergence of long-term market interest rates** towards the best performers in terms of credibility and low interest rates. The stability oriented macroeconomic policy framework, focusing on price stability and sound fiscal policies, has resulted in significantly reduced financing costs in most countries. Today, the European economy benefits from benchmark long-term market interest rates well below 4%, a level which most issuers have never seen in the last fifty years. The reduction in risk premia and the stabilisation in inflation expectations at low levels is a major achievement which must be maintained by today's and future economic policy making.

Fourth, a related success of the euro has been an improved **resilience against crises in financial markets**. For those who experienced the many episodes of exchange and interest rate volatility between the 1970s and the mid-1990s, it is clear that, without the single currency, events in recent years such as the financial crisis of autumn 1998, the turbulence that followed the September 11 terrorist attacks or the past swings in global exchange markets would have triggered major turbulences in European countries.

Last but not least, I would like to mention **the single monetary policy**, which has preserved price stability and credibility in a transparent manner. With a clearly defined mandate to pursue price stability in the Treaty and a strong focus on independence, the European Central Bank, together with the participating national central banks, has implemented the single monetary policy in the euro area since 1999. As you know, the ECB defines price stability as inflation rates below, but close to, 2% over the medium term. Looking back at the period since the introduction of the euro, actual inflation rates were not always in line with price stability, due to exceptional shocks such as the rise in oil prices in recent years. However, these shocks did not undermine the credibility of our promise to ensure price stability over the medium term and therefore did not derail inflation expectations. This was due to our medium-term orientation of monetary policy which is aimed at providing a stable anchor for economic agents. Indeed, the best contribution of monetary policy to economic growth is when inflation and inflation expectations are firmly anchored at price stability. One way of measuring our success in providing this long-term anchor is to study long-term market expectations for inflation. Taken all measures together, from financial markets or from survey data, the information indicates that we have been successful in stabilising inflation expectations at below 2%. But these measures also indicate that we need to remain vigilant as regards any upside risks to price stability over the medium term.

The understanding of how a central bank reacts to data and indicators is crucial for the anchoring of inflation expectations and for the credibility of monetary policy. The overall success of the ECB's monetary policy also reflects, in my view, a success in terms of **transparency and communication**. As a public institution providing a public good with full independence, we are responsible and accountable to the people of Europe. Consequently, a significant part of our job is devoted to explaining and discussing our actions and our goals to the public. From the start, the Governing Council has decided to communicate its assessment of the economic situation and of the risks to price stability in a new and exceptionally transparent fashion. Monetary policy decisions are explained at the press conference which takes place immediately after the first Governing Council meeting of the month; the ECB was the first major central bank to embark on such concept of transparency, and it was then followed by other important central banks. Further explanations of our policy are presented in the ECB's Monthly Bulletin, in speeches given by members of the Governing Council and in the testimonies of the President before the European Parliament.

Challenges

Let me now turn to two of the most important challenges we are currently facing and which need to be addressed in order to fully reap the benefits of the euro, namely raising potential economic growth and the enlargement of the euro area.

Let me start with the first challenge I want to discuss today, namely the **need to raise economic growth** in a sustainable manner. We all know that the growth performance of a number of euro area countries has been disappointing during the past years, both in a historical perspective and compared with other economies. This is also true since the start of the euro, despite the improved financing conditions I mentioned earlier. This reflects both international and domestic factors: The world economy is transforming rapidly, external competition has become stronger, knowledge is easily transferable and the ability to adjust to changing economic circumstances is increasingly important. Many European countries have not been adapting their economic, social and legal frameworks - set up under very different conditions - rapidly enough to face these challenges. At the same time, the age structure of Europe is getting increasingly unfavourable. In facing this challenge, the options are limited; we need to adjust our regulatory frameworks in product, labour and financial markets in a way that competitiveness and economic dynamism are maintained. Some countries in the euro area, which have done well in terms of maintaining high output and employment growth, demonstrate that such changes are possible not only outside Europe but also within.

At the EU level, the Lisbon Agenda constitute the main driver in this field. It aims at enhancing the knowledge-based economy and thereby productivity, increase labour participation and foster financial integration. Recently, the report prepared by the High Level Group chaired by Wim Kok provided an assessment of the Lisbon Strategy and stated that there had been a "disappointing delivery" on the agreed measures. The report expressed an urgent need for renewed impetus, stronger commitment of national governments and a sharpening of the Lisbon Strategy's focus on the acceleration of employment and productivity growth. It also regards the role of benchmarking as crucial. The ECB strongly welcomes these proposals, as they are well in line with our own views. Indeed, what matters for our future success is innovation, productivity enhancement and employment growth and all measures should be directed to achieve these results.

Let me further elaborate on a few areas in urgent need of reform. Most observers agree that further reforms in labour markets in many euro area countries are absolutely crucial in order to improve the quality, incentives and flexibility of labour supply. The current mix of tax and benefit systems continue to provide a disincentive to take up work or to work longer hours in many countries. Measures to make wage growth reflect more strongly regional and sectoral productivity differences would certainly be helpful. In addition, efforts by Governments to improve education and training systems to improve skills are to be supported. In product markets, substantial progress has been made during the 1990s with important effects on productivity, prices and employment. This is an encouragement to do more in terms of fully implementing the Single Market and reducing market entry barriers in national regulations which continue to hamper competition. Especially in the services sector, where most new jobs are created, sometimes excessive regulation still persists. Finally, I believe that further integration in euro area financial markets is possible, especially as regards the integration of equity markets, continued efforts to harmonise legal and regulatory frameworks, and the consolidation of the banking sector. Not only would these reforms raise potential economic growth, but they would also make the economies more flexible and thereby strengthen the resilience against shocks. This in turn would facilitate the pursuit of stability oriented macroeconomic policies.

Let me now turn to a second major challenge I see, namely **enlarging the euro area**. The historic EU enlargement with ten countries on the 1st of May last year was only a first step in the process of economic and monetary integration of the new Member States. None of the 10 new Member States have a special status as regards the introduction of the euro, implying that they are all expected to strive to fulfil the convergence criteria and subsequently to adopt the euro.

An important step in this process is to join the exchange rate mechanism ERM II, for which at least a two year membership is foreseen in order to comply with the exchange rate criterion. Although there are no formal criteria to be met for entry into ERM II, successful participation will benefit from having major policy adjustments - for example relating to fiscal consolidation and price liberalisation - undertaken before joining the mechanism. Otherwise, significant pressures on the exchange rate may arise which may jeopardise the convergence process. Having proceeded with the necessary structural adjustments, participation in ERM II can be an important means of anchoring exchange rate and inflation expectations and of promoting discipline. It can help orient macroeconomic policies to stability, while at the same time allowing for a degree of flexibility if needed, through the standard fluctuation band and the possibility of adjusting the central parity. This period can also be seen as a realistic experience of the capacity of Member States to respect the requirements of the Monetary Union, in which the exchange rate will no longer be available in order to adjust to changing economic conditions.

Before adopting the euro, all convergence criteria, relating not only to exchange rate developments but also to inflation, public deficit and debt, and long-term interest rates, as well as legal convergence, will need to be achieved in a sustainable manner. Only when all the criteria are met on a sustainable basis, will a country be eligible for adopting the euro. As it is an irreversible decision, joining the euro area is a very important step requiring careful preparation. Every country will be assessed on its own merits and its own particular situation. Whether this process will go swiftly or be more prolonged depends largely on countries' starting position, remaining needs for structural change and integration, and how successful they are in maintaining sound economic policies. While the criteria for sound and sustainable macroeconomic policies are crucial for the well functioning of the Monetary Union, they also make good economic sense for individual countries, both before and after joining the euro area. Ultimately, I am convinced that EU and euro area enlargement will contribute positively to economic growth and welfare in the whole EU.

Concluding remarks

Ladies and gentlemen, in conclusion, let me once again stress my firm belief that the Economic and Monetary Union has seen a number of successes in a very short period of time: the introduction a new currency for more than 300 million Europeans, the maintenance of price stability and low market interest rates and the promotion of financial integration. These successes, which are indispensable conditions for sustainable economic growth and employment, needs however to be complemented by further progress in other parts of the economy. I am referring in particular to the implementation of structural reform. In order to reap the full benefits of the EMU and to cope with the global competitive pressures, a truly dynamic economic environment will need to be put firmly in place. These issues have been identified and solutions have been drawn up, in particular in the Lisbon agenda. Now, the challenge is to implement these commitments. In this endeavour, the new Member States of the EU will undoubtedly make constructive contributions, benefiting from their recent experiences in restructuring their economies to the EU framework.

To some extent, all changes and new challenges impose feelings of fear and hesitation - most likely due to the simple fact that most human beings fear the unknown. We know what we got but we do not know what we will get, and this inhibits our actions. Such hesitation is natural but the success of the euro itself shows that a combination of insights, leadership, technical capacity and preparation can be channelled into a general enthusiasm to succeed and to rise to the challenge. While the euro is still a young currency, it draws on the cumulated wisdom of its legacy currencies. This combination of youth and experience is unique.

Thank you for your attention.