

Lucas Papademos: The euro and economic growth

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the Forum des Idées Économiques, Sciences Po, Paris, 15 April 2005.

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The euro and the single European monetary policy are now more than six years old. There are many issues that can be addressed concerning the consequences of the euro. In line with the focus of our session, I will concentrate on some key questions concerning the performance of the euro and its role in promoting growth.

- Has the euro performed well and met the expectations of the European public?
- Has the European Central Bank conducted the single monetary policy effectively and fulfilled its mandate?
- Has the overall performance of the euro area economy and of its individual Member States been satisfactory over the past six years? And, if not, what can be done about it?

The performance and value of a currency must fundamentally be judged in terms of its purchasing power. Consequently, it is the primary objective of the European Central Bank to safeguard the purchasing power of the euro by maintaining price stability in the euro area – which we have defined as maintaining inflation at close to but below 2% over the medium term. The statistics speak for themselves. In the first six years (1999-2004) following the introduction of the euro, average annual inflation in the euro area was 2.0%. This is a remarkable accomplishment, particularly if we take into account that during this period the euro area economy was subject to a large number of adverse shocks that caused inflation to rise temporarily above 2% for fairly long periods of time. These inflationary disturbances included oil price shocks, increases in food prices resulting from livestock epidemics, indirect tax increases and the undesirable effects on prices from the cash changeover to the euro. In spite of these sizeable adverse shocks, today we live in an environment of low inflation. The benefits of price stability are fully appreciated by the European public. For the citizens of a number of EU countries, the environment of low inflation should represent a marked change: after all, in the ten years preceding the introduction of the euro (1989-1999), average annual inflation in the 12 countries today forming the euro area was 8%.

What is more significant for the value of the euro and the credibility of the ECB's single monetary policy is that long-term inflation expectations clearly suggest that financial markets are confident that price stability will be maintained in the euro area over the long run. Similarly, from financial market indicators we can deduce that there is general trust in our ability to keep inflation low and in line with price stability over the coming years. At the same time, I admit that public perceptions of current inflation (as opposed to expectations of future inflation) have deviated significantly from the inflation recorded in some countries over the past three years following the cash changeover to the euro. This has been a cause for concern, not least because a negative attitude towards the euro could undermine the generally favourable expectations about future inflation. Fortunately, this gap between perceived and actual inflation, despite its puzzling persistence, has narrowed recently and should be eliminated soon.

All in all, a high degree of price stability has been achieved in the euro area in line with the ECB's mandate. But more than that, our stability-oriented monetary policy has acquired credibility and both short-term interest rates and long-term bond yields are at historically low levels in nominal and real terms. The prevailing favourable financing conditions, the low level of inflation and diminished inflation uncertainty continue to lend support to investment and have established an environment conducive to sustainable growth. As we all know, however, price stability and low interest rates define necessary but not sufficient conditions for faster growth. Other factors shaping an economy's growth potential and influencing the dynamics of aggregate demand play a crucial role in determining both growth and job creation.

On the growth front, developments have been less positive. Output growth and employment creation in the euro area have been unsatisfactory – indeed disappointing when compared with the high expectations which many people had when the euro was launched. Countries outside the euro area – especially the United States – have evidently outperformed the euro area. In the six years since the introduction of the euro, the average rate of growth was 1.9% in the euro area and 3.0% in the United

States. Furthermore, in the ten years prior to the introduction of the euro (1989-1999), growth in the euro area on average lagged behind that in the United States by almost 1%. However, it should be noted that the introduction of the euro is not associated with the increase in this growth gap.

Euro area averages naturally mask a variety of growth performances – outstanding and unsatisfactory – of individual countries within the single currency area. Ireland, Greece, Spain and Luxembourg have all recorded more than 3% growth on average since the introduction of the euro, while Germany, Italy and Portugal have grown barely 1.5% on average over the same period. This type of dispersion of growth rates is a natural phenomenon in any large economic area, whether in the euro area or the United States. Let me stress that the impression that output growth divergences are widening across euro area countries is not backed by facts. On the contrary, the degree of dispersion in real GDP growth rates across the 12 euro area countries declined in 2004 (in annual average terms) to a historically low level. In particular, dispersion, as measured by the unweighted standard deviation, fell to around 1.4% last year, while it had been fluctuating around 2% since the 1970s.

What is behind the low trend growth in the euro area? For an answer, we have to look at the determinants of potential or long-term growth, notably the rates of increase of population and productivity, and the degree of labour utilisation in the economy. This latter variable is determined by the labour force participation rate, the unemployment rate and the average number of hours worked. On all these counts, Europe does not score well – especially compared to the United States. Europe's population has been growing by a meagre 0.3% per year over the past decade; the United States' population by 1.3%. Our productivity growth rates lag behind those of the US by ½ to 1 percentage point (depending on the sector and period chosen). Only around 70% of Europeans of working age participate in the labour market – compared to over 80% of Americans. Euro area unemployment stands at around 9%, three percentage points more than in the US. And those who do work have shorter working hours. Europeans work, on average, about 250 hours less per year than Americans.

To argue that these facts simply reflect the preference of Europeans to enjoy more leisure rather than seek additional income is not sufficient. The causes are more complex. We should take a critical look at the way in which tax and benefit policies influence the incentives for companies to hire staff and for people to take up work.

In addition to these structural factors, the current phase of low growth is undoubtedly also due to low confidence, both among businesses and among consumers. Of course, this is not true to the same extent in all sectors and all countries, but on aggregate, we clearly observe a problem of low confidence. Several factors have adversely influenced confidence in the past few years: large increases in commodity prices, notably oil prices, and geopolitical tensions; the pressures of global competition; uncertainty and the short-term impact of certain reforms to modernise the welfare state and prepare social security systems for population ageing; and – last, but by no means least – uncertainty about the current and future stance of fiscal policies in many euro area countries.

If we can agree on this diagnosis of the reasons for low growth in Europe, the elements of a remedy are already emerging. The Lisbon agenda – especially after its recent refinement and refocusing, which the ECB strongly supports – addresses many of the structural weaknesses of the euro area economy. It is no coincidence that countries which score highest with regard to the achievement of the Lisbon goals are also the ones with the most robust growth performances over recent years. The example of the Nordic countries shows how reforms of tax and benefit systems can encourage labour participation; how investment in education and training and how greater diffusion of advances in information and communication technologies can spur productivity growth; and how structural reforms in labour and product markets – in a process of Schumpeterian “creative destruction” – can open up new avenues for growth. Robust growth in Europe is not a “mission impossible”. It can be done. And it can be done without abolishing the basic features of what we call the European social model.

Can it be done inside monetary union? The single monetary policy, conducted for the euro area as a whole, is playing its part already – notably by providing a low inflation environment with favourable financing conditions. And, of course, the euro has eliminated, once and for all, the intra-euro area exchange rate volatility. The revised fiscal framework of the Stability and Growth Pact – if implemented in a rigorous and responsible fashion – still has the capacity to guide national fiscal policies on a sustainable path, thus bolstering confidence, reducing uncertainty and fostering growth. But clearly, the onus is on national policies, especially structural policies to promote growth, competitiveness and employment. Thankfully, things are moving: throughout the euro area, we see governments embarking on structural reforms, some courageously, others somewhat more timidly. Some euro area countries – notably Germany, but also France, Austria, Belgium and Finland – have made significant progress in

improving competitiveness over the past few years. And competitiveness is a key determinant of long-term growth. Of course, Europe needs more reform progress; but the situation is more differentiated and more promising than the black-and-white, rather gloomy picture often portrayed.

The structural impediments to the euro area's growth must be addressed by implementing appropriate structural measures. There are no alternative solutions and no "quick fixes". The euro underlines the validity of this proposition as well as the need for systematic and determined efforts towards implementing the necessary reforms. As the euro area economy becomes more productive, flexible and competitive, its growth performance will improve, benefiting from both an enhanced capacity to produce as well as increased confidence that can boost investment and consumption.

Thank you for your attention.