# Lucas Papademos: The adoption of the euro and economic performance in Monetary Union

Public lecture by Mr Lucas Papademos, Vice-President of the European Central Bank, at the Central Bank of Cyprus, Nicosia, 26 November 2007.

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## I. Introduction

“A day will come when all the nations of this continent, without losing their distinct qualities or their glorious individuality, will fuse together in a higher unity and form the European brotherhood. A day will come when the only fields of battle will be markets opening up to trade and minds opening up to ideas.” It was the French writer Victor Hugo who proclaimed these almost prophetic words back in 1849. It is also said that Hugo planted a tree in the grounds of his residence and predicted that by the time this tree matured a united Europe would have come into being. The tree has grown impressively. And it is about to get another solid branch and fresh leaves, as the introduction of the euro in Cyprus in just over a month’s time will mark a further significant step on the path towards the integration of our continent. On such a historic occasion, I am honoured to be addressing this distinguished audience from the Central Bank of Cyprus, public institutions, academia and the financial sector in Cyprus. I would like to thank Governor Orphanides for his invitation and warm welcome, as well as the Central Bank of Cyprus, which has organised this event in close cooperation with the Chamber of Commerce and Industry, the School of Economics and Management of the University of Cyprus, and the Association for Social Reforms (OPEK).

The euro will be a tangible part of life for the people of Cyprus as of 1 January 2008. Its introduction crowns a broad-based reform process and a successful convergence effort, as well as thorough preparations for the changeover. By adopting the euro, Cyprus will take an irreversible step towards deeper economic and monetary integration within the euro area. One way of looking at this milestone in Cyprus’ history is to think of its entry into Monetary Union as being similar to a marriage. The partners should first think carefully about it, consider the likely consequences and be aware that a marriage implies not only privileges, but also commitments and responsibilities. The partners need to be prepared and ready to live together in good times and in bad times. In fact, entering Monetary Union is like a marriage without the option of separation or divorce. A country that joins Europe’s Monetary Union and those already in it becomes part of a “community with a common destiny”. In this sense, the dynamism of the Cypriot economy, and the welfare of its people, will be of relevance to all countries sharing the single currency; and equally, the stability and prosperity of the euro area will be of importance to the people of Cyprus. Thus, the well-being of the family as a whole should be in the minds of all of its members.

In my remarks today, I would like to address three interrelated issues concerning the implications of Cyprus’ joining the euro area family. I will start by briefly recalling Cyprus’ economic achievements in the run-up to its accession first to the European Union (EU) and then to the euro area. I will then look at what is needed in order for the euro area economy to function efficiently, focusing on the appropriate conditions and policies that will allow individual countries to fully reap the benefits of euro adoption. Finally , I will comment on the state of preparations for the introduction of the euro, indicating the elements essential to a successful changeover to the euro in this country.

## II. What are the major economic achievements and current policy challenges in Cyprus?

On its road to the euro, Cyprus has made remarkable progress in improving the living standards of its people, thanks to an extended period of stability-oriented macroeconomic policies. Income per capita has gradually been approaching that of the euro area, increasing from 74% of the euro area average in 1997 to 85% ten years later, while the unemployment rate has remained fairly low, standing at between 3.5% and 5% over the past decade. Moreover, inflation in Cyprus has for a long time been fairly well contained, standing at levels between 2% and 3% since 1997, with the exception of 2000 and 2003, when strong increases were observed in energy and food prices. This satisfactory and improved inflation performance over the past few years largely reflects a prudent and effective monetary policy, based on exchange rate stability, supported by efforts to liberalise product markets and network industries. It is, therefore, not a surprise that Cyprus is among the first of the new EU Member States to adopt the euro. And in many respects, Cyprus can serve as an example for other countries as regards the question of how to successfully pursue economic reforms and convergence.

A key feature of the policy framework in Cyprus has been its tradition of pegged exchange rate regimes, which dates back to the country's independence in 1960. Exchange rate stability, which has been effectively supported by consistent macroeconomic policies, has been instrumental in the expansion of trade, especially with the EU and the euro area, which is of particular value for a small and open economy like Cyprus.[1] In the area of fiscal policy, progress has been made. The public debt-to-GDP ratio in Cyprus, which peaked at 70.3% in 2004, has gradually been declining towards the 60% reference value laid down in the Treaty. That said, further steps will be necessary, not least in view of future challenges, such as an ageing population, and Cyprus' remaining fiscal imbalances.

In conclusion, the key factors in Cyprus' economic success have been the fact that inflation has remained contained and the favourable conditions for both real and nominal convergence. It is, therefore, fair to say – and I am pleased to say – that Cyprus is well prepared for its accession to the euro area. Congratulations! However, a strong commitment to both fiscal consolidation and further structural reform remains essential in order to reap the full benefits of being part of Europe's Monetary Union. After all, the purpose of achieving sustainable convergence is not only the fulfilment of the Treaty requirements for the adoption of the euro. It is equally important to achieve sustainable convergence in order to establish the necessary conditions for enhancing market efficiency, preserving price stability and improving economic welfare within Monetary Union. In other words, it is not just about making the grade, it is about being prepared for life. Non scholae, sed vitae discimus, Seneca reminds us, and life within Monetary Union is the topic to which I would now like to turn.

## III. What are the necessary conditions for the successful economic performance of the euro area as a whole and the individual member countries?

The first point to stress is that the adoption of the euro does not mark the end of the process of convergence to stability. Of course, a high degree of convergence has been achieved in order to join the euro area. At the same time, a new life starts inside Monetary Union, implying new opportunities and challenges for sustainable growth and stability. So what kind

[1] In 2006 export and import ratios stood at around 50%. In the same year exports of goods to the euro area and the EU accounted for 51% and 69% of total exports respectively, compared with figures of 17% and 28% in 1997. The corresponding figures for imports as a percentage of total imports were 55% and 67% in 2006, compared with 34% and 48% in 1997.

of family is Cyprus joining? What are the key features of the soon-to-be-enlarged euro area economy?

### *III.i Economic performance of the euro area*

Cyprus will enter a large economic area representing a zone of monetary stability with low inflation and low interest rates. Despite the large – almost unprecedented – number of substantial and prolonged adverse price shocks that have hit the euro area economy over the past few years, notably strong and persistent increases in oil prices, the ECB's monetary policy has succeeded in keeping inflation under control. Annual inflation rates have remained in the vicinity of our quantitative definition of price stability as embodied in our objective of keeping price increases below, but close to, 2%. At the same time, inflation volatility has, overall, declined considerably. As a result of this favourable track record and the credibility of the ECB's monetary policy, long-term inflation expectations in the euro area, for example those derived from long-term bond yields, have remained solidly anchored in line with price stability. This demonstrates that market participants have confidence in the ECB's ability to credibly deliver price stability over the medium and long term, in line with its Treaty mandate.

As a result of the ECB's credible commitment to price stability and the effectiveness of its monetary policy, the euro area has benefited from favourable financing conditions, with low inflation risk premia and low and less volatile interest rates, both in nominal and real terms, across the maturity spectrum. The elimination of exchange rate variability between euro area countries has reduced the volatility of the prices of internationally traded goods. Overall, the degree of macroeconomic stability enjoyed by the euro area over the eight years since the launch of the single currency has been remarkable, both by historical standards and when compared with that of other major economies, such as the United States.

Another important feature of the euro area economy is its significant ongoing structural adjustment as a result of the completion of the internal market, including the increasing integration of financial markets, and the implementation of reforms in most Member States aimed at strengthening competition, increasing market flexibility and efficiency, and raising labour utilisation. The integration of markets and the creation of the single European currency have had mutually reinforcing positive effects.

More specifically, greater price transparency across the euro area and reduced transaction and information costs foster competition and promote trade, with favourable effects on prices, investment and employment. As a result of these effects and the impact of labour market reforms, unemployment in the euro area has reached low levels not seen for 25 years, with the unemployment rate having declined sharply to stand at 7.3% in September 2007. Monetary Union has also fostered financial integration within the euro area, which – together with the use of the euro as an international currency – has contributed to a significant increase in savings, investment and funding opportunities for euro area households and firms. Finally, the euro area has been more resilient with regard to external developments and less vulnerable to exchange rate movements than its individual member countries were before the introduction of the euro. The financial market turmoil has also demonstrated that the ECB and the Eurosystem, as a collegial team, have the capacity, when necessary, to act in a decisive, swift and effective manner to ensure that orderly conditions are preserved in money markets and that the potential impact of financial shocks on the economy is mitigated.

### *III.ii Economic divergence in the euro area*

So far, I have looked only at the euro area as whole. As a representative of a supranational institution, this is in fact my privilege and duty. However, looking only at the aggregate data for the euro area as a whole also has its limitations, and average figures can conceal significant differences in performance. There is some degree of divergence in the economic performance of individual euro area countries, especially as regards their inflation, growth and competitiveness performance, and it is important to understand the causes and potential consequences of that divergence.

The level of dispersion seen in inflation rates in the euro area has declined substantially since 1999, standing at a level much lower than that of the previous decade, and is now broadly similar to that observed in the United States.[2] However, differences in growth rates among euro area countries have diminished only marginally over the past few decades, fluctuating, on average, around 2 percentage points, with no apparent upward or downward trend. Again, the growth differentials observed across the various regions of the United States are similar. With regard to unit labour costs, which are a key determinant of price competitiveness across countries, dispersion among euro area economies has declined markedly over the past few decades, and its magnitude is broadly in line with what we are seeing in the United States. However, in recent years we have observed some worrying developments.

Although inflation and growth differentials across the euro area are not unusually large, we should nevertheless seek to understand their causes and nature given their potential implications for future economic performance. A first significant finding of empirical analysis is that the dispersion of growth rates across the euro area can largely be explained by differences in trend output growth – reflecting structural factors such as the effects of reforms recently implemented – rather than different cyclical developments. To the extent that such differences in trend output growth are related to normal and positive catching-up processes in the economies of some countries or are the consequence of persistent idiosyncratic shocks, they are not a cause for concern per se and need not have longer-term detrimental effects on inflation, economic activity and job creation. On the contrary, they may be seen as a manifestation of a desirable equilibrating mechanism, contributing to sustainable convergence among euro area countries.

A second salient feature of the divergence observed in economic performance across the euro area countries is its persistence. Very often the same set of countries are characterised by developments in key economic variables that are systematically either above or below the euro area average. This may suggest that the underlying adjustment mechanisms in the euro area economies are not functioning as smoothly or swiftly as they should. If the persistence of higher than average inflation and stronger than average unit labour cost growth reflects structural rigidities in a country's economy and the implementation of inappropriate policies, this is a matter of concern because of the likely adverse effects on competitiveness, long-term growth and employment creation.

### *III.iii Necessary conditions and appropriate policies for the efficient functioning of Monetary Union*

To optimise the economic performance of Monetary Union, to fully reap its potential benefits in terms of economic dynamism and welfare, job creation and increased per capita income, it is crucial to improve the functioning of product, labour and financial markets. To this end, well-designed and effectively implemented structural reforms and sound fiscal policies are essential in all euro area countries. Since monetary policy and the exchange rate are no longer available at the national level as policy instruments and a means of adjusting to specific shocks and the challenges posed by globalisation, other adjustment mechanisms become even more important.

[2] At the beginning of the 1990s the level of dispersion of inflation rates across the euro area countries was, on average, around 6 percentage points (standard deviation measured in unweighted terms). In 2006 inflation dispersion was only 0.7 percentage point. This implies that dispersion in the euro area is currently broadly in line with inflation dispersion among the key 14 US Metropolitan Statistical Areas, where it has fluctuated around 1% in the last two decades.

In this context, wage and price flexibility plays a pivotal role. The smooth functioning of the price mechanism is a prerequisite for the efficient allocation of resources across different sectors and over time. In the same vein, the mobility of capital and labour across countries and regions and between different sectors is of particular importance in a monetary union. It is therefore essential that governments establish an institutional framework which allows the economic adjustment processes to function efficiently and effectively, and which helps to set appropriate incentives for economic agents and thus enhances the overall growth performance of the economy.

In this respect, I am pleased to say that substantial progress has been made over the past few years. Previous labour market reforms, for example, have contributed to robust employment growth and lower unemployment rates in the euro area. In Cyprus, the labour market is already relatively flexible, with significant flows of foreign and seasonal workers, which exert a favourable influence on economic activity and domestic unemployment and contain inflationary pressures.

However, further progress is needed. In Cyprus, too, additional structural reforms are essential. For instance, the indexation mechanism for salaries should be overhauled and ultimately eliminated in order to reduce the risk of inflation inertia, which will eventually have adverse effects on real income. Such reforms will, therefore, not only make the economy less vulnerable to shocks, but also improve the conditions for sustainable economic growth and job creation. Of course, the implementation of reforms is greatly facilitated if there is public acceptance of them. This is a formidable challenge which should be effectively addressed. President Woodrow Wilson observed that “the most ardent reformers have had to learn that too far to outrun the […] masses was to render themselves powerless”. It is, therefore, crucial to explain clearly and convincingly to the public that any short-term adjustment costs associated with structural reforms will be more than outweighed by their long-term benefits in terms of stronger income and employment growth.

The other essential condition for the efficient functioning of Monetary Union is the implementation of sound fiscal policies. These contribute to a stable macroeconomic environment, they provide room for manoeuvre in order to cushion the effects of the business cycle and, by reducing debt-servicing costs, and they allow governments greater scope for pursuing economic and social objectives. In recognition of these benefits, and in view of the observed propensity of governments to spend more than they receive in revenue, Monetary Union has been complemented by a set of fiscal rules to ensure fiscal discipline, notably the Stability and Growth Pact. Within a monetary union, budgetary developments in one country are a matter of common concern for all, because all countries have to deal with the negative consequences of inappropriate fiscal policies.

The Stability and Growth Pact allows for the effective surveillance and coordination of Member States’ budgetary policies. The Pact is based on a system of “peer support” which should be positively embraced by national governments in the planning and execution of their budgets. For countries with fiscal imbalances, this implies, for example, the use of windfall tax revenues for fiscal consolidation rather than for additional spending or tax cuts. Most importantly, the Pact provides the appropriate policy framework for addressing country-specific fiscal challenges.

In the case of Cyprus, the fiscal deficit has declined, but the government has yet to reach its medium-term budgetary objective. To this end, an annual improvement in the structural balance of 0.5 percentage point of GDP is necessary and required by the provisions of the Pact. Budgetary plans for 2008 are difficult to reconcile with this consolidation benchmark. The current favourable macroeconomic environment provides a window of opportunity for progress towards achieving a sound medium-term fiscal position sooner rather than later. After all, as has been said before, the best time to repair the roof is when the sun is shining! Therefore, it would not be appropriate to succumb to any siren songs urging the use of the current strong revenues to finance increases in expenditure. A structural weakening of the budgetary position will sow the seeds of a rapid deterioration in public finances when economic developments turn out to be less favourable than expected.

Beyond this, there are further fiscal challenges which should be kept in mind, for instance those related to the projected substantial increases in public expenditure pertaining to population ageing, which is in fact already among the highest in the EU. It is, therefore, essential that sufficient room for manoeuvre be created in public finances before the demographic situation worsens. Moreover, depending on the specific economic and fiscal arrangements, a possible reunification of Cyprus could impose substantial budgetary costs.

Another pertinent issue is the need to improve the quality of public finances, which can help enhance business and growth conditions and allow for a reduction in the overall level of public spending. In Cyprus, as in many other euro area countries, public expenditure is still high by international standards. A leaner public sector could be more efficient and, at the same time, more effective. In this context, moderate wage developments that take into account labour productivity growth, labour market conditions and developments in competitor countries can make an important contribution to fiscal consolidation and employment growth.

To sum up, experience has shown that the economic well-being of individual countries participating in Monetary Union depends on their ability and willingness to effectively implement sound fiscal policies and structural reforms. As we know, there are a number of countries that have managed to fully reap the benefits stemming from membership of the euro area, while other countries have performed in a less satisfactory manner than could legitimately have been expected by their citizens. But this undesirable outcome and policy failure is certainly not the fault of the euro.

Finally, membership of the euro area also brings with it the privileges and responsibilities of participation in joint decision-making. As a member of the ECB's Governing Council, Governor Orphanides will also contribute to decisions on the monetary policy stance. Likewise, the staff of the Central Bank of Cyprus will be fully integrated into the work of the Eurosystem committees, working groups, task forces, etc. that play an important role in the Eurosystem's functioning. Naturally, we at the ECB and in the Eurosystem are very pleased to have Governor Orphanides as a new member of the Governing Council and to welcome the Central Bank of Cyprus into the "Eurosystem team". Last, but by no means least, Cyprus, as a euro area member country, will also be involved in the decision-making as regards all other issues pertaining to Monetary Union.

## IV. What is needed for a successful changeover to the euro?

Will the euro be a success story in Cyprus, too? I am confident that it will be. But the extent of the success will depend, as I have argued and as the experience of other countries suggests, on several factors. It will depend on whether the people in this country using the new currency believe in its stability. In this respect, the ability of the ECB to credibly deliver price stability for the euro area as a whole should be reassuring. It will, furthermore, depend on the implementation of appropriate policies. And it will also depend on whether the people of Cyprus have confidence in the safety and integrity of their new currency. An important aspect in this context is a smooth cash changeover to the euro – logistically, in terms of public information and as regards the conversion of prices.

I am pleased to say that with regard to the technical aspects of the changeover, Cyprus is on the right track. Numerous tasks involving many different areas of expertise have either been completed or are being completed: the selection of the designs for Cypriot euro coins, the printing and distribution of notes, and the preparation and translation of comprehensive campaign material to make the people of Cyprus familiar with the visual appearance and security features of the euro banknotes and coins, as well as with the modalities of the cash changeover.

Unquestionably, a well-informed public is crucial for the successful introduction of the new currency. Drawing on the positive experience of previous changeovers, such as that of Slovenia at the beginning of this year, various communication channels are being used. There are ten different publications in Greek, Turkish and English; 350,000 information leaflets are currently being distributed to all Cypriot households; media seminars have been organised. In all of this, we have paid particular attention to vulnerable groups. I personally was particularly impressed by the "talking cards". Following consultations with associations for the blind, we developed an audio file which allows visually impaired people to receive the relevant information on the cash changeover and the euro.

The information campaign has been very intensive, not only in terms of financial and human resources, but also in terms of coordination efforts among all relevant parties, including the Central Bank of Cyprus, the ECB, the Cypriot Ministry of Finance and the European Commission. After the changeover, we will evaluate the campaign, and I expect that the countries seeking to join the euro area at a later stage will be keen to learn from Cyprus' experience.

In the remainder of this year, some final preparations are still necessary. The delivery of coins, minted by the Bank of Finland, and the delivery of banknotes, provided by the Bank of Greece from the Eurosystem stock, has started. And in a week's time starter kits for the public will be distributed. The dual circulation of the Cyprus pound and the euro will last one month. Afterwards the euro will be the sole legal tender in Cyprus, but Cyprus pound coins can be exchanged for two more years and banknotes for ten more years at the Central Bank of Cyprus.

Finally, let me reassure you that we are taking the concerns of the people of Cyprus very seriously as regards possible unwarranted price increases in the context of the euro changeover. We have to monitor the situation carefully to ensure that prices are converted properly and the euro changeover does not provide an opportunity to raise prices in an unjustified manner. Having seen the positive outcome of price-watching in this country, it is clear to me that Cypriots are vigilant consumers. We are aware that food and oil prices have been rising noticeably in recent weeks, and some people may come to attribute these increases to the changeover to the euro. But let me emphasise that this is not a phenomenon affecting only Cyprus. All of the citizens of the euro area are, regrettably, confronted with these price increases, which are mainly due to supply constraints in international markets. It might be easy to blame the euro. But it would not be right! If anything, the euro has actually helped to dampen the rise in oil prices, given its recent appreciation on the foreign exchange markets.

## V. Concluding remarks

In just over one month's time, Cyprus will be part of the euro area. It will join a large economic area that last year accounted for around 15% of world GDP and is a zone of monetary stability characterised by sound economic fundamentals. The euro area economy is expected to continue to grow at rates close to trend potential. However, this positive outlook is currently surrounded by heightened uncertainty and is subject to downside risks. The ongoing process of risk reappraisal and repricing in financial markets could be more protracted than previously expected and may have a broader impact on financial markets and the economy. This process can be seen as a correction of the underpricing of risks seen in recent years, especially those risks associated with particular segments of the markets for credit and structured finance products. At the same time, the tensions and volatility experienced in some financial markets underline the importance of effective methods and prudent practices in the assessment and management of risk by financial institutions and investors. This is essential in order to ensure that the benefits of financial innovation for market efficiency and economic growth are safeguarded by means of adequate risk management and sufficient market discipline. The ECB will continue to pay great attention to financial market developments in the coming period and will take the necessary measures to ensure the orderly functioning of the money markets.

The outlook for price stability is also subject to a number of upside risks. Inflation in the euro area, which accelerated to 2.6% in October from 2.1% in September, is expected to remain at an elevated level significantly above 2% in the coming months, before moderating again in the course of 2008. The acceleration of inflation in the euro area is due to the unfavourable impact of developments in energy and agricultural prices, which could persist for some time. Moreover, there is a risk of wage developments being stronger than has been seen to date and stronger than currently expected, given the existence of capacity constraints in some markets and the improved labour market conditions. It is, therefore, of the utmost importance that the increase in inflation does not affect medium to long-term inflation expectations and second-round effects are avoided.

The ECB is prepared to act in an effective and timely manner to ensure that risks to price stability over the medium term do not materialise and inflation expectations remain firmly anchored in line with price stability. This is all the more important at times of financial market volatility and heightened uncertainty. At the same time, given this uncertainty, continuous and very close monitoring of all developments is necessary and a thorough examination of additional information is warranted before further conclusions are drawn regarding the monetary policy stance needed to preserve price stability over the medium term.

The current conjuncture seems to point to an uncomfortable, though temporary, combination of higher inflation and somewhat slower economic growth in the coming months. Inflation risks and financial market volatility confront us with significant challenges. It should be clear, however, that the maintenance of price stability over the medium term is the primary objective of the ECB's monetary policy. It should also be apparent that being inside a monetary union provides an economy with a shield that can help to weather a potential storm that could adversely affect economic activity and inflation. That said, the privilege of enjoying this protection and its effectiveness are intertwined with the responsibility of each country to keep its own house in order and make its own contribution to the prosperity of the monetary union as a whole. In other words, and to come back to my initial metaphor, it is just like a real family, where the joys and comfort of togetherness are complemented by mutual commitments and shared responsibilities. With these words, let me conclude: Congratulations again, and welcome to the euro area family!

Κύπρο, καλωσόρισες!