Willem F Duisenberg: Business conditions and the economic outlook in the euro area

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the 75th anniversary of the International Chamber of Commerce Deutschland, Berlin, 26 October 2000.

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Ladies and gentlemen,

1. Introduction

We have come together to celebrate the 75th anniversary of the International Chamber of Commerce Deutschland. Early in the last century, the founders of the International Chamber of Commerce were convinced that trade was a powerful force for peace and prosperity. Although dreadful years were to come, I think they were right. In a way, Europe has built up on this very same idea over the past half century, from the start of the European Coal and Steel Community to later developments such as the single market and, as a corollary of that, the introduction of the single currency. In this respect, there have thus been clear parallels in thinking among policymakers and entrepreneurs. The International Chamber of Commerce of today still stands for the principle of open international trade and investment in a free market economy. That this principle has been promoted in Germany for 75 years now, is indeed worth a "Festakt".

The topic of my speech today is "Business conditions and the economic outlook in the euro area". While I cannot give you any golden rules on how best to conduct business in the euro area, I can say something about the environment in which business is conducted. This environment can be split into two characteristic parts, both of which are highly important for doing business: first, the structural economic environment and, second, the conjunctural economic environment. I shall talk about both today. Regarding the structural environment, I shall focus on those developments in the euro area which make it increasingly one large integrated market. On the conjunctural environment, I shall discuss the outlook for the economy of the euro area.

The main message is that, from my point of view, the prospects for doing business in the euro area are favourable, as the structural environment is clearly changing for the better and the conjunctural economic environment is good.

2. The structural environment

Let me start with reviewing the structural economic environment.

Given that we are celebrating a 75th anniversary, allow me to dwell somewhat on history. It was just after the Second World War that western Europe began its process of integration. It started in 1948, after the countries receiving Marshall Aid set up the Organisation for European Economic Cooperation, which later became the Organisation for Economic Cooperation and Development. Soon afterwards, plans were made for more far-reaching forms of economic cooperation, looking for the possibilities for free trade. One of those plans, the so-called Schuman plan, was a French initiative, which was welcomed by Germany, Italy and the Benelux countries. In 1952, the six nations concerned created the European Coal and Steel Community, the first common market, albeit only for a limited number of products. Plans to eliminate more trade barriers began to emerge and, in 1957, the six countries signed the Treaty of Rome establishing the European Economic Community (EEC). The EEC was to become a customs union for industrial products, without any custom duties for trade within the Community and with common tariffs for trade outside the Community. The subsequent broadening and deepening proves the success of this Community. Developments in the last decade have further promoted free trade.

First, the foundations of a level playing field were laid with the creation of the Single Market in 1992. This enhanced the possibilities for business by extensively reducing the regulations on cross-border trade within Europe. Second, this Single Market project was supplemented by the single currency, the euro, which has been introduced in, thus far, 11 of the 15 Member States of the European Union. Economic and Monetary Union has created a "zone of stability" in Europe, by eliminating exchange rate fluctuations between these eleven countries, by establishing a common monetary policy aimed at price stability for the area as a whole and by the commitment of the fiscal authorities to the Stability and Growth Pact. A stable public policy environment is expected to foster business activity, as it lowers the risk premia paid either implicitly or explicitly in many transactions. The clearest example of a reduction in the risk premia resulting from Monetary Union is the fact that there is no longer any need for currency hedging in transactions across the countries of the euro area.

Through the introduction of the single currency, the euro area of today can thus increasingly be perceived as one large market. It is a market that extends from Lisbon to Helsinki and - in the near future - from Dublin to Athens, as Greece will be joining Monetary Union as from 1 January 2001. In terms of its population, the euro area market is even larger than that of the United States - it has about 300 million inhabitants, some 10% more than the United States, and it is expected to grow even further, as more countries will probably join in the future.

The euro area thus constitutes one large market. Of course, that market is still evolving and has not yet reached its ultimate state of development. For example, the euro as such currently exists only in the financial markets and, to some extent, in the business sector. Consumers still calculate and pay in their own national currency unit, which is a handicap for increasing awareness of the euro. This will end with the cash changeover in 2002, which tends to be perceived by the general public as the true start of Monetary Union. In itself, the cash changeover is a gigantic logistic operation. Moreover, there will be a period in which both the old national currency units and the euro will circulate simultaneously.

The cash changeover will also achieve one of the main advantages of the single currency: transparency of prices in all markets. This will further facilitate the emergence of a truly single market, because it will be increasingly difficult to maintain price differentials for the same or similar products between countries. Even though market segmentation may occur for various reasons, such as the particular tax situation or different technical specifications, pressure will increase on both entrepreneurs and regulators, as consumer and large retail organisations will become increasingly aware of the price differences.

But there are more things to do to further integrate the euro area markets. There still exist structural rigidities in many countries, which affect the proper functioning of product and labour markets. A continuation both of moderate wage settlements and of structural reforms will be essential contributions to a further improvement of the functioning of European markets. The introduction of new technology requires flexibility of other factors, including labour, if production processes are to be reorganised most efficiently. If there are limits and restrictions to the adjustment to the most profitable combination of productive factors, the levels of investment in the new technologies will accordingly be affected negatively.

It must be noted that the introduction of the euro has contributed to the awareness of policymakers throughout Europe that structural reforms are needed. And although many reforms have yet to be implemented, substantial progress has nonetheless been made. Governments have acted in the field of product markets in order to make them more competitive to the benefit of consumers. The favourable impact that opening up sectors to competition has on prices, growth and employment has become clear in the telecommunications and energy sectors. The challenge now is to further reduce the level of regulation so as to stimulate activities in other sectors of the economy.

With regard to the fiscal position, there is a relatively high tax burden and there are still a number of countries with a very high debt ratio. Fiscal policies must thus be firmly committed to the requirements of the Stability and Growth Pact in order to enhance the soundness of public finances. However, it is important to remember that the Treaty, supplemented by the Stability and Growth Pact, reflects a broad agreement and provides for basic principles in the field of fiscal policy. In particular, it requires that countries in the EU, and especially those that have adopted the euro, respect a common code of fiscal conduct that is expected to uphold discipline in the management of government finances.

In this respect, a remarkable evolution can already be seen. The fiscal position of euro area countries could, on average, show a substantial improvement this year. In part, this is due to stronger growth and substantial one-off windfall gains from mobile telephone licences. But it is also the reward for many years of fiscal reform, which started in the run-up to Monetary Union. In several Member States, major tax reforms are planned. The ongoing and planned tax reductions are welcome steps towards reducing distortions in the economy and producing positive supply-side effects. However, they should be fully offset by primary spending cuts to prevent a pro-cyclical loosening of fiscal policy.

As regards the financial markets, the introduction of the euro has led to a unified money market throughout the euro area. Before the start of Economic and Monetary Union, criticism was sometimes heard to the effect that the decentralised monetary policy framework was bound to become too complex and inefficient. However, from a technical point of view, highly developed information technologies make decentralisation entirely feasible. Consequently, after almost 22 months of experience with this system, such criticism is no longer heard. There seems to be almost unanimous agreement that it works well. Indeed, the rapid integration of the euro area money market, with the crucial support of an integrated payment systems infrastructure, in particular the “TARGET” system, was a precondition for the successful implementation of the Eurosystem’s monetary policy.

There still remains a need to further develop financial markets in Europe - especially with regard to the provision of risk capital. However, the introduction of the euro has, in fact, involved a process of integration of national financial markets, which is increasing the size and liquidity of the financial market and fostering its depth and breadth. The European financial system is changing rapidly. Although it is still predominantly bank-oriented, the change is clearly in the direction of a greater role for markets. There has, for example, been a rapid growth of the euro-denominated private bond market. The euro did not cause this trend, but it has given it a major impetus.

The process of monetary policy-making and its implementation has functioned efficiently. The evolution both of external inflation forecasts and of inflation expectations derived from the analysis of long-term interest rates (in particular, index-linked bonds) indicates that the financial markets and economists widely expect medium-term price developments that are in line with the ECB’s definition of price stability. Obviously, bond yields and many external forecasts incorporate expectations of future policy changes and therefore offer a judgement on prospective monetary policy decisions, as well as on decisions taken in 1999 and 2000. As such, they provide a positive assessment of the overall monetary framework. Actual inflation in 1999 stood at 1.1%, compatible with price stability. Although inflation has increased this year, it is still relatively low, both historically and compared with the United States, for instance.

Above all, as indicated earlier, Monetary Union has proven to be a catalyst for major improvements in the structural economic environment. In this respect, there is thus also reason to expect that the euro area could benefit over time from the advances in the new technologies, as the United States has apparently been doing already.

Europe is thus changing and much has already been achieved. The advances are noteworthy, although they are not always appreciated, not even by Europeans themselves. There remains a great deal to be done in order to further upgrade the structural environment. However, this in itself creates opportunities for the future as there is a large potential to be exploited.

3. Outlook for euro area economy

Let me now turn to the conjunctural side of the economic environment.

Where economic growth is concerned, the euro area economy has impressively overcome the negative mood prevailing in early 1999, recovering to reach a state of affairs not seen for more than a decade. Real GDP growth in the euro area has shown a strong performance since mid-1999, with four consecutive quarters of 0.9% growth, quarter-on-quarter, and the forces underlying sound growth in the medium term remain in place. The external environment remains favourable. Domestic demand is expected to continue to be strong as well. Consumption is benefiting from high consumer confidence and further increases in employment, and investment is being stimulated by higher corporate profitability and increasing rates of capacity utilisation. Domestic financing conditions are also good. This positive outlook for growth is confirmed by available forecasts from international institutions, such as the IMF and OECD, as well as by Consensus forecasts, which project growth in the euro area in the next one to two years to be higher than in 1999, with an increase from close to 2½% last year, to above 3% this year and the next.

It is true that recent indicators suggest that, following the period of acceleration, the economic expansion may now be levelling-off, albeit at a robust pace. Growth in industrial production excluding construction has decelerated somewhat recently. The Purchasing Managers' Index declined in the course of the summer, which would indicate that a turning point may have been reached in year-on-year growth of industrial production. At the same time, however, the index still points to continued strong rates of growth after the first half of this year. Moreover, sustained high levels of industrial confidence, as shown by the EC survey, suggest that growth remains robust. Although consumer confidence fell in September, it remained clearly above its long-term average.

However, the possibility cannot be ruled out that the significant increase in oil prices observed in the past months may temporarily dampen growth dynamics over the short term. Thus far in October, oil prices - measured in terms of UK Brent - have remained above USD31 per barrel. If oil prices were to develop according to futures prices for the remainder of this year, the oil price increase for 2000 as a whole would amount to more than USD10, compared with the average price in 1999. The oil price increase has caused the terms of trade of the euro area to deteriorate, and has thus also had a certain negative impact on the growth of real income for the economy as a whole. However, it can be noted that the reduced oil dependence since the first oil shock in 1973 limits the overall impact of any price rise. Against the background of a generally favourable economic outlook, the increase in oil prices can be seen as occurring at a point in time when euro area economic activity should not be overly sensitive to shocks of this kind.

The oil price increases have influenced recent price developments and still continue to do so. The same holds true of the depreciation of the euro exchange rate. Overall inflation, as measured by the Harmonised Index of Consumer Prices (HICP), may well remain above 2% for a more protracted period than expected earlier. We are currently seeing the direct effects of such external developments on the HICP rate of inflation, which was 2.3% in August and 2.8% in September. Looking at the HICP excluding energy, the rise in September was 1.6%.

The ECB has as its primary objective to maintain price stability. Price stability is defined as a year-on-year increase of below 2% in the Harmonised Index of Consumer Prices for the euro area over the medium term. The main tool which the ECB has for maintaining price stability is the control of short-term interest rates. However, interest rate changes only impact prices after some lag. The ECB thus aims at maintaining price stability over the medium term. The current oil price and exchange rate developments cannot be remedied by monetary policy in the short term. However, it is imperative that medium-term upward pressure on prices be contained.

The ECB has increased its interest rates in steps by a total of 225 basis points since November 1999. The gradual tightening of monetary policy was needed to preserve the prospects for price stability, thereby contributing to sustainable output and employment growth in the medium term. A monetary policy committed to price stability is the best way to ensure that monetary policy makes its full contribution to overall economic welfare. By pre-emptively responding to threats to price stability, both sharper increases in interest rates at a later stage and pronounced swings in economic activity can be avoided.

The challenge is to translate the current cyclical upswing into a sustained period of robust non-inflationary growth. The key to a lasting increase in the growth potential of the euro area lies in the continuation of structural measures to enhance the flexibility of the labour and goods markets and in the maintenance of sound public finances. Governments must avoid the mistakes of the past, when fiscal policies were relaxed in response to the effects stemming from the increases in energy prices. At the current juncture, fiscal policies should avoid any pro-cyclical bias and should aim at reaching sustainable fiscal positions in the medium term more quickly. In addition, it will be important for social partners to continue to act as responsibly as they have done in the recent past. Wage moderation has made an important contribution to the progress observed thus far in job creation and in reducing unemployment. Indeed, employment has grown by 1.8% in 1999 and by over 2% in the first half of 2000. And, since the start of Monetary Union, unemployment in the euro area has fallen by 1.5 percentage points, although it still remains relatively high at a rate of 9%. Any attempt for wages to catch up in reaction to recent oil price increases would be highly detrimental to the current favourable growth prospects, since monetary policy would need to react to the resulting upward pressure on prices.

4. Conclusion

Let me conclude at this point. The structural environment is clearly changing. Over the past decade or so, there has been a drive to integrating markets in Europe. The euro area, with its single currency, will increasingly be perceived as one large market. This creates many opportunities for business within the euro area. It also creates challenges as competitive forces increase. These will no doubt intensify after the physical introduction of the euro. This will make consumers and enterprises increasingly aware of the existence and benefits of the common currency and will focus the spotlight on still existing price differences in the euro area. The structural environment also poses challenges for policymakers, as the economy is still facing structural rigidities and a relatively high tax burden. However, the potential offered by the large euro area market is clearly already there to be exploited.

Given the changes for the better on the structural side, I am confident that the euro area offers excellent opportunities for doing business. The current growth prospects are favourable and Europe can rely on a central bank which is firmly committed to maintaining price stability. This will serve to further promote what the founders of the International Chamber of Commerce had in mind: peace and prosperity.