Jean-Claude Trichet: EMU and the euro - successes and challenges

Speech by Mr Jean-Claude Trichet, President of the ECB, delivered at the conference "The Euro Five Years After", Amsterdam, 12 October 2004.

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Ladies and gentlemen, it is a great pleasure to share some thoughts on the European Monetary Union with the distinguished attendance gathered in this conference by the European Commission and the EU Presidency.

The establishment of the new currency - first in book-entry form and successively in its full physical embodiment - has made western Europeans fully part of a more integrated area and is substantially contributing to reinforce their European identity. More recently, the enlargement of the Union, and in particular the inclusion of the new democracies of Central and Eastern Europe, has represented yet another grand contribution of Europe to the diffusion of free institutions, the safeguard of geopolitical stability and peace, and the promotion of economic progress on a global scale. We have decided to build a larger and peaceful Union of people to which the rest of the world can look for encouragement and example.

It is around these themes that I will organise my few remarks today. My purpose will not be that of communicating a sense of complacency over past achievements. I will try to convey in my words the visionary drive towards action that still inspires the process of institutional transition in our Continent. We have not stopped to catch our breath after the euro change-overs, and we will not pause for a moment after the enlargement. In fact, the historical process of European integration that was initiated in Rome in 1957 is keeping momentum and will keep us occupied - I am sure - for long.

The birth of the euro

Sceptics were unconvinced as to whether it was possible to make the euro a stable currency and to successfully formulate a monetary policy for a supposedly diverse currency area. Where do we stand almost six years later? The euro has been firmly and credibly established as a stable currency. The euro area has brought with itself a period of currency stability, low rates of inflation and low levels of medium and long term market interest rates that generations in many countries had never seen before. The introduction of the euro, first, in book-entry form, and, second, in the form of banknotes and coins went extremely well under the presidency of my predecessor Wim Duisenberg to whom I would like to pay homage. The euro has become part of people's daily lives.

In January 1999, the transition to the euro in book-entry form was virtually free of implementation problems, although many people had predicted that such a big project would inevitably be delayed or affected by technical glitches or organisational failures. This complex task, involving more or less simultaneous changes in countless computer programs at central banks, stock exchanges, authorities and thousands of private institutions, was carried out smoothly and in a perfectly coordinated fashion. Carefully crafted contingency measures - which would be activated in the event of a breakdown of the "core infrastructure" - assisted the migration of all electronic systems and procedures. Eventually, no incidents occurred after the irrevocable fixing of the conversion rates for the euro. On 4 January 1999 the Eurosystem announced the successful completion of its first main refinancing operation.

There remained looming concerns about how rapidly and smoothly the national money markets would integrate as we were aware that creating an efficient single money market also depends upon the creation of a tight network of contractual agreements between market players across the euro area. Of course, an integrated euro area money market is a precondition for the very execution of a single monetary policy and for an efficient allocation of central bank money across market participants.

In fact, the national money markets formed an efficient integrated euro area-wide circuit within a couple of weeks - faster than we had dared to hope. Overnight rates across the euro area converged rapidly, with only negligeable differences remaining.

In this respect, TARGET - the real time gross settlement system of the euro area - has been a decisive supporting factor and has, in particular, contributed to the rapid integration of the money market. The TARGET system, developed by the Eurosystem, links all the real-time gross settlement payment systems in the European Union. The payment volumes processed daily in the TARGET system far exceed our initial expectations and the system had a market share of almost 70% of the total volume of large-value payment transactions in the euro area already in the first months of 1999. This percentage has been increasing in the following years to reach almost 90% in July 2004.[1]

The euro cash changeover

Three years after the birth of the euro, the exchange of the legacy national banknotes and coins of the 12 countries of the euro area for the new euro notes and coins was a huge organisational, logistical and technical undertaking. A number of observers rightly called it the most important logistical endeavour in time of peace. This euro cash changeover progressed well to the benefit of more than 300 million European citizens.

If banknotes and coins are to be put into circulation, they first have to be produced, which in itself was an unprecedented challenge. For banknotes alone, we assembled and co-ordinated a total production capacity of some one billion banknotes per month. The banknotes incorporate state-of-the-art security features, had to be available within a fixed timeframe and be identical both in the eyes of the public and when read by machine sensors, given that they are legal tender throughout the euro area irrespective of where they were originally issued. In total, more than 51 billion coins had been minted and around 16 billion banknotes printed at the end of 2001.

The second phase of the operation involved putting the new currency into circulation and withdrawing national banknotes and coins, an operation that impacted the 300 million inhabitants of the euro area and many more outside it. Things worked out well because of good preparation: advance planning, communication, co-ordination and thorough follow-up and control have all been vital. It is worth mentioning the success of the slogan “the euro. Our money”, which reached a worldwide audience through television and newspaper advertisements, web pages, starter kits, and the 200 million leaflets written in a total of 38 official European languages, regional languages of European countries and other world languages. On 1st January 2002, the reception of the new currency was surrounded with confidence and, even, an element of enthusiasm across the euro area.

The mandate of the ECB

The citizens of the euro area received the new currency with a sense of confidence. But since the euro was not created in an institutional vacuum, it is important to recall which factors have enabled us to make the euro a credible currency which was immediately adopted. I would name here, most importantly, the institutional framework of Economic and Monetary Union. The Maastricht Treaty has written in stone that monetary policy is to be conducted with the aim of maintaining price stability and that the ECB is fully independent. These provisions were designed to ensure long-lasting credibility to the euro from its outset, by, in particular, sheltering monetary-policy from external pressure.

The credibility of the ECB is reflected in low, medium and long-term inflation expectations. And this credibility was already high at the start of Economic and Monetary Union. I well remember that at that time some observers argued that the quality of the euro as a new currency would converge only towards a sort of an average of the legacy currencies, rather than to the benchmark set by the most credible ones. What happened is that, all along the yield curve, the euro area’s market interest rates became aligned with the lowest market rates prior to the euro. The euro area’s 300 million inhabitants benefited immediately from the best possible financial environment, from the credibility that had been built gradually in certain parts of the euro area over the previous decades, without losing a single basis point.

Nominal and real interest rates have remained at those low levels ever since. They have also consistently reflected a high degree of consonance between the ECB’s policy intentions on the one hand and the market understanding as regards the course of policy on the other. In other words, the level of predictability of policy - a highly regarded sign of transparency for a modern central bank - has been elevated by any international standards.

Indeed, predictability and transparency go hand-in-hand. In order to successfully maintain price stability, we constantly have to make all the reasons underlying our decisions transparent to the public.

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[1] Source: http://www.ecb.int/stats/payments/payments/html/04_table2.en.html

The announcement of the monetary policy strategy in October 1998, before the introduction of the euro, was a milestone in this regard. It clearly stated the ECB's understanding of its objective and the framework used to guide policy decisions. In addition, the Governing Council's assessment of the economic situation and the risks to price stability are regularly published and monetary policy decisions are explained in a press conference that I and the Vice President give immediately after each monthly meeting in which monetary policy is discussed ; in this respect, the ECB has been very bold in its communication policy, as the usual practice of central banks in 1999 was to release their diagnosis about 6 to 8 weeks after the meeting of their decision making body; by providing a comprehensive explanation of its decisions almost in real time, the ECB has certainly set new standards of transparency in the world of central banking. We are convinced that transparency is a prerequisite for accountability and enhances the understanding among the markets of how the central bank conducts its monetary policy, thereby promoting predictability and supporting substantially policy effectiveness.

The need for structural reforms

While EMU has been highly successful in restoring and furthering macroeconomic stability in its founding members, a number of economies in the euro area still have to undertake important actions to fully realise the advantages of a stable single currency. Structural economic impediments in a number of participating countries reduce employment opportunities and hold back the creation of real income compared to the pace that would be attainable, were available resources put to their most efficient uses. Insufficient productivity growth - coupled with unfavourable demographic trends - in turn undermine the sustainability of social security systems. In many countries these systems incorporate relatively generous provisions for insiders to the disadvantage of younger and more deprived cohorts of citizens. It is therefore widely recognised that a much better functioning of the labour markets, together with reforms of social security and protection, and the timely completion of the single market of goods and services, including financial services, would be significantly needed to improve the prospects of the euro area.

In this respect, the ECB has very much welcomed and supported the impetus given by the Lisbon European Council to the economic reform process. The diagnosis of the situation that emerges from the Lisbon discussions is pertinent and unambiguous. As pointed out by a recent report written under the auspices of European Commission[2], it is time for the European Union and its members to translate words into actions, especially in areas such as job creation, investment in research, and liberalisation of services. The European Union needs an economic and social model aiming at facilitating adjustments into new employment rather than the excessive protection of unproductive jobs. Investments are needed to build more efficient infrastructures. We need better support for research and development activities, and also improvements in our policies regarding human resources and education. All these measures are key for productivity in the European Union to pick up and are of utmost importance to make the single market work better to the benefit of all Europeans.

Structural reforms that are designed to increase the flexibility of markets permit a higher level of sustainable long-run growth and employment. They furthermore enhance the capacity of the participating countries to cushion macroeconomic shocks. The more rigid labour, product and financial markets are, the higher will be employment and income losses experienced in response to changing domestic and external economic conditions. This is due, in particular, to the fact that with nominal rigidities prices and wages cannot adjust suitably and in a timely manner. Conversely, the speedier adjustments of wages and prices can take place in response to changes in macroeconomic conditions, the lower will be the burden of adjustment put on volumes and thus the lower the costs in terms of employment and output losses.

We recognise that the implementation of structural reforms requires courage and leadership. Especially, they may temporarily be perceived negatively by some economic agents. However, after some time, employment is expected to increase, as new products and services are being introduced and fresh energies are being unleashed and made productive. The liberation of large segments of activity that were previously suppressed will soon create a potent constituency for reform and

[2] European Commission (2003): “Jobs, Jobs, Jobs. Creating More Employment in Europe”, report of the Employment Taskforce chaired by Wim Kok, November.

structural advancement. Importantly, all consumers and firms which in a regulated environment had to bear the cost of financing the subsidies will immediately enjoy the benefits from the reform.

These prospective gains and the tilting of the balance of social preferences that these gains will bring about are often overlooked in the public debate. In fact, for the time being, the challenge to gain the support of parliaments and the public for implementing structural reforms is formidable. It is therefore imperative to make it clear to the public that, if governments and social partners deliver those reforms, the net benefits will be significant for the public at large.

Fiscal policy

Implementing structural reforms to raise potential growth is a major challenge for the European economies. But it is not the only one. In any economy, achieving sustainable, non-inflationary growth also requires fiscal soundness. In the absence of such fiscal soundness, price stability can only be maintained at a higher cost in terms of interest rates, and thereby lower growth and employment.

What is appropriate for all economies is all the more necessary at the euro area-wide level, where, in the absence of a federal budget, a credible framework ensuring fiscal discipline is a key component for the consistency and the cohesion of our monetary union. Sound fiscal policies implying safe budgetary positions in good times are necessary to ensure that fiscal policy has room to cope with asymmetric shocks, which can no longer be addressed by monetary policy. Not least for these reasons, it is a matter of concern to the ECB that in a number of Member States abnormally large fiscal deficits have persisted over years.

The Commission has tabled some proposals and a discussion has been launched to consider how to strengthen and clarify the implementation of the Stability and Growth Pact. We can find common ground between some of the Commission's proposals and our own thinking, namely, as regards the preventive arm of the Pact. We agree that the implementation of the Stability and Growth Pact should be improved. We agree that ownership and incentives for compliance need to be enhanced. And we agree that implementing the Pact in a way that best reflects its economic rationale should help to achieve this end.

At the same time, making the rules exceedingly complex and contingent on too many circumstances would complicate the implementation of the framework to the point where rules would be de facto relaxed. Therefore we are of the opinion that the so-called "corrective arm" of the Pact must preserve the nominal anchor of 3%. The Stability and Growth Pact requires simple and transparent rules in order to facilitate effective monitoring; to provide an effective deterrence against unsound policies; and at the end of the day, to provide an anchor for long-term expectations, which only the clarity, simplicity and credibility of the framework can offer. In this respect, the wording of the Treaty and of the regulations of the Stability and Growth Pact is appropriate in its current form and in our view should not be changed.

The historic EU enlargement

The introduction of the euro as a stable single European currency was not the last challenge to be faced by the ECB and the European Union in general. The recent enlargement of the EU has been an expansion of the European Union of exceptional historical dimension.

The ten new countries represent 75 million people and their GDP is up to 4.8 % of the former EU 15. This enlargement and its anticipation has provided significant new opportunities for trade and investment. These effects are visible in the enhanced degree of economic integration between the new and the old Member States. Trade integration is very substantial. For example, the share in the previous 15 Members' total exports and imports that is accounted for by the 10 new Members States now stands at around 12-13 % - an increase of some 50% since 1995. Capital integration has also increased dramatically over recent years, as the share of the new Member States in the previous Members' total FDI outflows amounts to around 12 %. But both economic theory and empirical records lead us to believe that more is to come. Lower trade costs and an increase in competition associated with the enlargement of the European Single Market can have a significantly positive impact on growth in the European economy as a whole. Some economic studies point to an increase, ceteris paribus, of 0.8 % of the EU GDP over the next ten years.

But accession has also been a powerful catalyst of domestic change for the countries that have entered the Union. Many of these new Members have made remarkable progress in recent years, especially in terms of macroeconomic stabilisation and structural reforms. There still remain, however, important challenges. The task at hand is to advance real convergence. Safeguarding and, where necessary, enhancing domestic conditions of macroeconomic and financial stability is an important institutional precondition. In particular, locking in inflation at low levels, preserving the soundness of the financial sector and making determined efforts towards fiscal consolidation are all of the utmost importance.

Enlargement of the EU will lead to an expansion of the euro area at some time in the future. The main aim of the Eurosystem in this process is to ensure that the monetary integration of the new Member States proceeds in a smooth manner and in line with the Treaty provisions. We should certainly not forget that as the new Member States differ greatly in terms of economic structure, exchange rate and monetary regimes, and in the degree of nominal and real convergence already achieved, they will need to be assessed on a case-by-case basis throughout the process leading to the eventual adoption of the euro. In this respect, no single path towards ERM II and the adoption of the euro can be identified. In other words, many strategies may be feasible, provided they are based on sound economic reasoning, conform to the existing institutional framework and contribute to the high level of sustainable convergence which is essential in maintaining the status that the euro has gained in the few years of its existence as a respected and credible currency.

We should also consider that the eventual adoption of the euro by a new Member of the EU is the end-point of a structured convergence process in which peer surveillance is called upon to preserve the common interest of all participants. The multilateral nature of the framework means that, at least at the ultimate stage in which full integration into the euro area is debated, decisions concerning one country or one currency are collective decisions. And this simple fact argues for the fundamental principle of equal treatment. So, while each country would be considered according to its specific merits, comparable situations and cases will be assessed on the levelled playing field provided by objective criteria. There will be no additional criteria but neither will there be a relaxation of the criteria that proved effective in steering the process of convergence across the founding members of the euro area.

Conclusion

Let me underline four points which, I trust, are of the essence in the present situation :

First, I would like to stress the remarkable credibility of the euro and of the Central Bank that issues this currency, the European Central Bank. Neither the ECB nor the Euro existed six and a half years ago! Today we have a currency which is as stable as were the best national currencies in Europe, and a Central Bank which is as credible as were the most credible Central Banks in Europe and in the world. Our duty is to fully preserve and enhance this exceptional level of credibility and I am, as President, fully committed to this task. Let me in this respect pay homage today to Finn Kydland and to Edward Prescott, who were awarded yesterday the Nobel Prize in Economics. Their seminal work - as regards central banking - on the importance of time consistency, commitment in advance, and full independence and credibility in the delivery of price stability over time has been very important for institutional developments around the world, including the ECB and the Eurosystem, and instrumental in our success. We owe them a particular debt of gratitude.

Second, price stability is a necessary condition to obtain sustainable growth and job creation. It is not, alone, a sufficient condition. We also need in the Euro area sound public finances and bold reforms. These two goals are closely correlated to the extent that a number of structural reforms in the domains of public administration and social protection would diminish overall public spending. We encourage the Eurogroup of Ministers of Finance to proceed resolutely in this direction under the presidency of Gerrit Zalm today and of Jean-Claude Juncker tomorrow.

Third, let me say simply that I find the present enlargement a formidable success for all our democracies that have voluntarily created together a new concept of a union of sovereign states which has no precedent in history. Of course we have many challenges associated with the fact that we are 25 today and more tomorrow. But we should not lose sight that we will all “10” and “15” greatly benefit from the success of our ideas.

Fourth, we are living in demanding times. The world is changing. Europe is changing. Future changes look rather unpredictable. I would consider this unpredictability as the very mark of history in the making. And I will never forget what Jean MONNET noted in his memoirs: “Those who decide not to start any enterprise because they are not assured that things will move in strict conformity with their plans are condemning themselves to absolute immobility. Nobody can say today what will be the shape of tomorrow’s Europe because future changes that will be born from present changes are unpredictable.”

Ladies and gentlemen, thank you for your attention.