Jean-Claude Trichet: Euro in wider circles

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Conference “Goodbye Lisbon” organised by the European Banking Congress, Frankfurt, 19 November 2004.

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Ladies and gentlemen,

It is a pleasure for me to share with you some thoughts on the euro in wider circles. Reflecting on what the term “wider circles” means for the euro, I think of the EU Member States that still use their national currencies and that aim to adopt the single currency in the future, and in particular the ten new Member States that joined the EU earlier this year and their path towards the euro. Let me briefly say a few words on this aspect.

The euro goes east

It is now 15 years ago that the Berlin Wall fell, giving rise to one of the most astonishing political and economic transformations in European history. Who could have imagined 15 years ago that in May 2004, eight countries in central and eastern Europe, together with two countries in the Mediterranean, would be members of the European Union? The perspective of joining the European Union and eventually adopting a European single currency was out of sight for even the most imaginative minds. In only 15 years, these countries managed to restore and entrench democratic institutions and market economies, replacing the communist ones that were imposed there before.

The accession of ten new countries to the EU was an important milestone in a process that will lead to the eventual adoption of the euro by these new Member States. The euro will go east and south and the road to the adoption of the euro is embedded in a well-defined institutional framework. A crucial phase before euro adoption is ERM II membership for at least two years. Although there are no formal criteria to be met for entry into ERM II, successful participation in the mechanism requires that major policy adjustments - for example relating to fiscal policy and price liberalisation - are undertaken before joining the mechanism. Participation in ERM II is an important means to anchor exchange rate and inflation expectations and to promote consistently sound policies. It helps to orient macroeconomic policies to stability, while at the same time allowing for a degree of flexibility, if needed, through the wide standard fluctuation band and the possibility of adjusting the central parity.

As you know, three new EU countries have in the meantime entered the ERM II: with effect from 28 June 2004, Estonia, Lithuania and Slovenia joined Denmark as participants in the mechanism. The three new entrants joined with a standard fluctuation band of ±15% around their central rates against the euro, while Estonia and Lithuania kept their currency boards as a unilateral commitment. In order to ensure a smooth participation in ERM II, countries have firmly committed to take the necessary measures to preserve macroeconomic and exchange rate stability. Participation in ERM II has been smooth. The four currencies in the ERM II have traded continuously at or close to their central rates, while short-term interest rate differentials vis-à-vis the euro area have been small.

Beyond ERM II membership lies the adoption of the euro, the crowning achievement of the monetary integration process. In order to adopt the euro, non-participating EU Member States have to achieve a high degree of sustainable economic and legal convergence. Every country will be assessed on its own merits and its own particular situation, on the basis of a strict analysis of the performance relating to the Maastricht convergence criteria. Let me stress that there is no pre-set timetable for the enlargement of the euro area.

Economic challenges for the new Member States

How far are the new Member States on this road towards the euro? The countries that joined the EU this year have shown impressive economic growth rates and have made great strides in reducing inflation. They belong to the most dynamic economies in the EU, having gone through profound structural changes. For example, they have taken thorough measures to reform their product and labour markets, and some new Member States, in some respects, may be even more advanced than other, existing EU countries. They have become more integrated with the euro area, with the major
part of their trade now occurring with the euro area and tight financial links: as a matter of fact, the share of the new 10 Member States in the total external trade of the euro area stands around 11%, compared with around 14% for the US and 3% for Japan. In addition, the transition process has brought their economic structures closer to those of the euro area. At the same time, while remaining a diverse group in many respects, the new Member States still display distinct economic characteristics that differ from the euro area. Their income-per-capita and productivity levels are still low relative to the euro area, which may have an impact on their inflation rates.

Let me mention two particularly important economic challenges that the new Member States are confronted with on the road to the euro: price stability and fiscal policy. Price stability is an essential requirement for a successful monetary integration process. Inflation rates in many new Member States have picked up recently to an average of almost 5%, following increases in food and energy prices and indirect tax changes. The challenge for the new Member States is to contain inflation and inflation expectations in an environment of rapid catching-up. Besides solid macroeconomic policy frameworks and prudent wage policies, progress in structural reforms is conducive to price stability by improving the supply side of the economy and enhancing the growth potential.

This brings me to the second challenge that I want to mention: the need to achieve sound fiscal positions. Fiscal deficits are on average high or even very high in a number of new Member States and mostly despite very high economic growth. Their governments are confronted with competing expenditure demands, including public investment in infrastructure and the need to strengthen the effectiveness of public administration and the judicial systems. This, however, should not be seen as an excuse to delay fiscal consolidation, but as an additional reason to design and implement a credible consolidation path based on durable and growth-enhancing structural reforms. It is important to bear in mind that fiscal consolidation in the new Member States becomes increasingly important in the course of the monetary integration process and it is essential for a smooth participation in ERM II and the eventual adoption of the euro.

**Conclusion**

Let me conclude. The historic enlargement of the EU is now six months ago and I think we can say that is has been a genuine success. Following a remarkable transformation in the past 15 years, the further integration of the new Member States into the European family has progressed smoothly and without any disruptions. The new Member States have shown an impressive economic performance, though various important challenges still remain to be fully tackled, including those relating to the recent pick-up in inflation and to fiscal imbalances.