Jean-Claude Trichet: The success of the euro and its impact on European companies

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Congress on Small-sized Enterprises, organised by Confindustria, Bari, 18 March 2005.

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Signore, Signori,

è per me un grande piacere contribuire oggi al dibattito sulle sfide poste alle imprese italiane ed europee dalla crescente concorrenza internazionale.

Circa centoquaranta anni fa Italia, Francia, Belgio e Svizzera diedero vita all'Unione monetaria latina al fine di accrescere la concorrenza, gli scambi commerciali e, in ultima analisi, il benessere. L'unione si fondava sull'accettazione reciproca delle monete in oro e in argento dei rispettivi paesi. L'esperimento tuttavia fallì. Dopo un lungo periodo di forti oscillazioni del valore relativo delle monete, accompagnate da elevata instabilità macroeconomica nei paesi aderenti, l'Unione monetaria latina venne sciolta al termine della prima guerra mondiale.

Quale lezione possiamo trarre da questa prima esperienza? E quali sono state le carenze di questo progetto? A mio avviso mancavano quattro elementi fondamentali: stabilità politica, un mercato comune, criteri di convergenza e una banca centrale comune. Per la realizzazione dell'Unione monetaria latina non era stato svolto alcun preparativo sul piano macroeconomico e fiscale, né era stata creata una banca centrale comune che mettesse in atto le più basilari misure di controllo valutario congiunto. A ottantacinque anni dalla fine dell'unione possiamo affermare di avere imparato dall'esperienza passata.

In un quadro caratterizzato da stabilità politica, quaranta anni di integrazione economica, commerciale e finanziaria hanno aperto la strada all'Unione monetaria europea.

Stabilità dei prezzi e solide politiche di bilancio hanno costituito il fondamento dell'Unione monetaria negli ultimi sei anni e vanno pertanto preservate anche in futuro. Quest'oggi mi soffermerò in primo luogo su quelli che considero i principali successi dell'euro per le imprese europee e, più in generale, per i cittadini europei. In estrema sintesi, stabilità macroeconomica, integrazione finanziaria ed efficienza economica rappresentano importanti conquiste dell'Unione monetaria, indispensabili al fine di promuovere la crescita economica e la creazione di occupazione da parte delle imprese europee.

In secondo luogo, mi soffermerò sulle aree che necessitano ancora di riforme volte a migliorare la competitività e quindi a favorire una crescita economica sostenibile. La stabilità monetaria e un contesto economico più aperto, efficiente e concorrenziale richiedono importanti iniziative complementari da parte dei responsabili delle politiche economiche nazionali. Mi riferisco al bisogno urgente di completare il processo di attuazione delle riforme strutturali, principalmente nei mercati del lavoro, dei beni e servizi e dei capitali.

Inizio ora a illustrare i principali successi dell'euro realizzati finora.

Ladies and gentlemen,

It is a great pleasure to be here today in order to contribute to the debate on the challenges that Italian and European enterprises are currently facing with respect to increasing global competition.

To enhance competition, trade and ultimately welfare, about 140 years ago Italy, France, Belgium and Switzerland gave birth to the Latin Monetary Union. This monetary union was based on the mutual acceptance of each other's gold and silver coins. That experiment failed. After a long period of strong fluctuations in the relative values of gold and silver, combined with high macroeconomic instability across the member countries, the Latin Monetary Union was finally dismantled by the end of World War I.

Can we learn something from this early experience? What was missing? In my view there were four key missing ingredients, namely, political stability, a Common Market, the existence of convergence criteria and a common central bank. No macroeconomic and fiscal preparations were made before the start of the Latin Monetary Union, no common central bank was in place to exert even the simplest measures of joint monitoring over currency issues. 85 years after the end of that regime we had clearly learnt our lessons.

In a framework characterized by political stability, a history of 40 years of economic, trade and financial integration had paved the way for the European Monetary Union.

The stability oriented macroeconomic framework, based on price stability and sound fiscal policies, has been the basis of the Economic and Monetary Union (EMU) in the past six years, and we should keep this framework in place in the future. Today I will first discuss in some detail what I see as the main successes of the euro for European enterprises and more in general for European citizens. Macroeconomic stability, financial integration and economic efficiency have been key achievements of EMU. These achievements are of utmost importance for enhancing lasting growth and employment creation of European companies.

Secondly I will reflect on the areas which still require reforms in order to raise competitiveness and ultimately economic growth in a sustainable manner. Monetary stability and a more open, efficient and competitive economic environment require important complementary initiatives by national policy makers. I am referring to the urgent need to complete the process of structural reforms, chiefly in the labour, product and capital markets.

Let me start with the key successes of the euro to date.

Successes of the euro

Six years after the start of EMU, we can already count successes on a number of fronts.

First, the success of the euro was a technical success. The **integration of money markets** enabled a smooth implementation of the single monetary policy from early January 1999. The transformation of European **financial markets** brought about by the euro has been remarkable. The global trend of closer financial market integration witnessed in the past decade has received a distinct additional boost by the introduction of the euro in EMU countries. The introduction of the euro has dismantled barriers to cross-border trading and enhanced risk sharing and opportunities for diversification. The elimination of exchange rate risk has increased the depth and breadth of financial markets and boosted financial innovation. Government bond yields have become nearly perfectly correlated in the euro area. There is also evidence of closer integration of stock markets in the euro area than elsewhere[1]. The euro had a particularly significant impact on the European market for corporate bonds, with a considerable increase in the number of medium-sized firms placing issues outside their home country. Financial deepening has of course benefited the Italian markets as well. In Italy, between 1999 and 2003 the volume of funds raised directly on the financial markets by firms issuing shares, bonds and other instruments grew from 31 billion to 65 billion euro. Over the same period the amount of Italian households' financial wealth held in the form of corporate securities increased from 22 to 36% of GDP.

Financial integration has facilitated the consolidation of financial structures, thereby increasing cross-border corporate linkages. In recent years, large flows of foreign direct investment among euro area countries have exemplified this intensification of corporate linkages.

The second key success of the euro relates to the **convergence of long-term market interest rates** towards those of the best performers in terms of credibility and low interest rates. In most countries, including Italy, this convergence has meant significantly reduced financing costs, thereby providing an environment favourable to growth and employment. Thanks to the stability oriented macroeconomic policy framework, focusing on price stability and on sound fiscal policies, - that is the two missing elements of the Latin Monetary Union - risk premia have declined and inflation expectations have stabilized at low levels. Today, the euro area economy benefits from benchmark long-term market interest rates below 4%, a level which most issuers have never seen in the last fifty years. In Italy the 10-year interest rate spread versus the best performers fell from 4.5 percentage points at the beginning of 1996 to 0.3 percentage points at the beginning of 1998 and to 0.2 percentage points at the end of 2004 [see Chart 1]. These two major achievements must be maintained by today's and future economic policy making.

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1 Robin Brooks and Marco Del Negro (2002), "International stock returns and market integration: a regional perspective", IMF Working Paper WP/02/202.

As a third point I would like to mention the **improved resilience of the euro area economies against financial crises** that the euro has brought about. Also in this respect, European corporations and, amongst them, Italian enterprises have largely benefited from the single currency. Italy as well as many other European countries experienced several episodes of large exchange rate and interest rate volatility between the 1970s and the mid-1990s. Without the single currency, events in recent years - such as the turbulence that followed the September 11 terrorist attacks or the swings in global exchange and stock markets - would have triggered major turbulences in Europe as a whole and in many euro area economies, including Italy. This, of course, does not mean that external factors have no longer been an important driving force in determining the economic performance of the EMU countries in recent years. However, euro area economies proved to be more resilient to external shocks in the 2001-2003 downturn, which were mainly caused by a correction of stock market prices and financial instability, than to the external shocks in the downturn of the early 1990s, which were mainly driven by exchange rates volatility.

Fourth, let me highlight **the convergence of inflation rates** to low levels across euro area countries thanks to the adoption of stability-oriented macroeconomic policies. A remarkable convergence among euro area member states took already place over the 1990s, triggered by the preparations for EMU, and this process has continued in the years after the start of the EMU. Measured by the standard deviation, the dispersion of inflation rates has more than halved in the period 1999-2004 with respect to the years preceding the monetary union. Low and stable inflation has been a fundamental achievement for the euro area as a whole as well as for Italy. Italian inflation was 4% in 1996 while in the countries that are now part of the euro area it was on average equal to 2.3%. In subsequent years Italy saw a significant reduction in its inflation gap vis-à-vis the euro area average, despite many adverse shocks that hit both Italy and the euro area in recent years [see Chart 2]. Between 1999 and 2004 Italy inflation averaged at 2.4% and euro area inflation at 2%.

Between 2001 and 2003 Italy saw a sizeable increase of perceived inflation [see Chart 3]. The concept of perceived inflation aims to measure changes in the inflation rate which consumers think that have occurred in the recent past. Usually we can observe a good correlation between the behaviour of actual and perceived inflation, which means that consumers have a relatively correct perception about the changes in their purchasing power. In Italy and in some other countries the patterns of actual inflation and perceived inflation started to diverge after the introduction of the euro. While this is a feature which should not be ignored, since what consumers decide to spend depends on their perceived real income, it is now important to acknowledge that it was a temporary phenomenon, and that during the last year and half the gap between actual and perceived inflation has narrowed significantly.

Notwithstanding the many adverse shocks that hit the euro area in the past years, **price stability** has prevailed in the euro area. The success of the single currency in delivering price stability and stabilizing inflation expectations in the euro area can be explained by the European institutional framework and the principles followed by the European Central Bank. First, the European Central Bank is independent and has a clearly defined mandate given by the Treaty to pursue price stability. Second, the ECB has provided and made public an arithmetical definition of price stability corresponding to inflation rates below and close to 2%. Third, the medium-term orientation and the very nature of our concept of monetary policy contributes to a solid anchoring of medium and long term inflation expectations, in line with our definition of price stability.

The best contribution that monetary policy can provide to economic growth is to maintain price stability. Price stability ensures the transparency of the relative price mechanism, thus enhancing the efficiency of resource allocation. Stable and low inflation supports private consumption via its positive impact on the real value of households' income and wealth. Price stability reduces the borrowing costs for individuals and firms. As we all know, inflation erodes the purchasing power of the nominal return on long-term loan contracts or bonds. In case of high and uncertain inflation, savers or those who lend their liquid funds would require a higher rate of return from borrowers, in order to compensate for the higher risks related to the uncertainty about future inflation. This inflation risk premium implies that in an economy with high inflation, less investment projects will be profitable. In such circumstances, capital accumulation will be lower than it could have been in a situation of price stability and the potential output growth rate is consequently reduced.

The challenge of economic growth

Let me now turn to some issues which still need to be addressed. The Economic and Monetary Union has secured macroeconomic stability, has promoted financial integration and led to convergence of inflation and interest rates to low levels. The key question that naturally arises is the following: Why has economic growth, nonetheless, remained subdued? In my introduction I have already hinted at my answer by referring to the need for completing structural reforms. Let me now elaborate further on this urgency.

The first message I would like to convey is that the **need to raise economic growth** in a sustainable manner is a common challenge for most of the euro area countries and for the euro area as a whole. The need to introduce supply side changes, aimed at boosting potential output growth is a common challenge to most European countries. Over the last decade real GDP growth has averaged just 2.1% in the euro area [see Table 1], significantly below the 3.4% growth rate of the US.

The second point I would like to make is that **competitiveness** is a key driver of sustainable growth. In recent years euro area companies have been facing stronger external competition, especially from low-cost producers in the very dynamic Asian economies, but also from those in the new EU Member States. It is the reason why unit labour costs are such an important indicator, particularly in a single currency area. Let us look at Italy as an example but there are many others in the euro area. In Italy nominal unit labour costs in the total economy and especially in the manufacturing sector - the most export oriented sector - have grown significantly faster than in the euro area as a whole. Let me just mention a couple of figures. Over the last six years, in Italy the cumulated growth rate of unit labour cost in the manufacturing sector was equal to 15.7% against a euro area average of 3.1% [see Table 2a]. What has been driving the strong rises in unit labour costs? On the one hand the cumulated growth rate of compensation per employee has been equal to 16.7%, on the other hand the cumulated growth rate of labour productivity has been equal to 1.1%. There seems to be something in the wage mechanism that prevents compensation developments from following more closely productivity developments. Besides this problem, such protracted weak labour productivity growth needs to be related to intrinsic difficulties in using labour and capital efficiently, possibly due to a lack of innovation. Why is that happening? A number of recent comprehensive reports[2], notably by the Banca d'Italia, ISTAT, Confindustria, and various Italian think-tanks, have emphasized a broad range of institutional and economic factors behind the Italian labour productivity-competitiveness problem. Some of them are discussed at your conference today and tomorrow. These factors include rigidities in product and labour markets, features of the financial system and corporate governance, low spending on research and development.

All these factors have certainly worked against the efforts of Italian enterprises to increase their size and to improve competitiveness by renewing their products and reallocating resources towards new, more dynamic sectors[3] [see Chart 4].

The lack of innovation might be partially related to the small-size of firms, which continues to be a predominant feature of the Italian industrial system. In that regard the business environment continues to create obstacles to firm-size expansion and to the entry of new and more efficient firms, thus hampering productivity growth. The costs of opening and closing a business as well as the time required to complete the legal processes involved in enforcing contracts remains well-above the euro area average[4] [see Table 3].

These considerations bring me to my third and final point: **structural rigidities** have slowed European firms' responses to structural changes in the production process. As a result, and in contrast to more flexible economies in the international sphere, many economies in Europe have not fully reaped the benefits of the technological advances of the last ten to fifteen years. Many European countries have not adapted their economic, social and legal frameworks in order to face the new challenges triggered by a rapidly transforming world economy.

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2 Banca d'Italia (2004), "Relazione del Governatore sull'esercizio 2003", Roma, May 2004. Banca d'Italia (2005), "Bollettino Economico", n.44, March 2005. Pierluigi Ciocca, (2003), "The Italian Economy: a Problem of Growth", Banca d'Italia, Economic Bulletin, 37, 145-158, November. ISTAT (2004), "Rapporto Annuale: la situazione del Paese nel 2003", ISTAT, Roma, May.

3 Tommaso Padoa-Schioppa (2001), "La competitività dell'Italia", Speech held at the Congress on Small-sized enterprises, Parma, 17 March.

4 World Bank (2004), Doing Business Indicators.

A sense of urgency to implement structural reforms was transmitted to European policy-makers last February when the European Commission proposed a "Partnership for Growth and Jobs"[5] as the core of a renewed Lisbon strategy, by putting forward a program of priority actions. These priority actions can be summarized under three key headings: (1) to extend and deepen the Single Market; (2) to build better infrastructure, motivate investment in research and development and facilitate innovation; (3) to attract more people into employment, improve the flexibility of labour markets and invest more in human capital through better education and skills.

Let me further elaborate on this priority list. The objective of **extending and deepening the Single Market** would imply to eliminate market entry barriers in national regulations which continue to hamper competition. This objective would also require improving national and European regulations in terms of simplification, well shaped legislation and effort to reduce the burden of administrative costs. The need of **fostering knowledge and innovation** would require more effective public expenditure and more favourable incentives for companies to engage in innovation and Research and Development. The need of **attracting more people to employment** would imply in many countries a "re-thinking" about the current mix of tax and benefit systems, which continue to provide disincentives to take up work or to work longer hours. Furthermore, measures to make wage growth reflect more strongly regional and sectoral productivity differences would certainly be helpful.

The European Central Bank strongly welcomes these proposals. They are fully in line with our own views. Indeed, the drivers of success are innovation, productivity enhancement and employment growth and all measures should be directed to achieve these results. Some European countries that are ahead in the process of adopting such changes show that these reforms are able to deliver higher output and employment growth. Not only would these reforms raise potential economic growth, but they would also make the European economies more flexible and thereby strengthen the resilience against economic shocks. This in turn would facilitate the pursuit of stability oriented macroeconomic policies.

Concluding remarks

Ladies and gentlemen, you are gathered here to discuss the way ahead in order to increase competitiveness and economic growth. In conclusion, let me once again stress that the maintenance of price stability, low medium and long term market interest rates, thanks to this stability, and financial integration are key successes of the Economic and Monetary Union as well as fundamentals conditions to enhance sustainable economic growth, employment creation and welfare. In order to reap the full benefits of the single currency and to cope with global competitive pressures, a truly dynamic economic environment needs to be put firmly in place. Be assured that the European Central Bank backs the drive towards reforms that is in motion in Europe since the Lisbon consensus in 2000. The European Central Bank backs the renewed Lisbon strategy and the Governments of Europe that are embarking courageously on those structural reforms. We do not underestimate the difficulties of the task and the necessity to explain tirelessly to the people of Europe that all will be better off thanks to these reforms. We consider we have to fully participate in this pedagogic exercise.

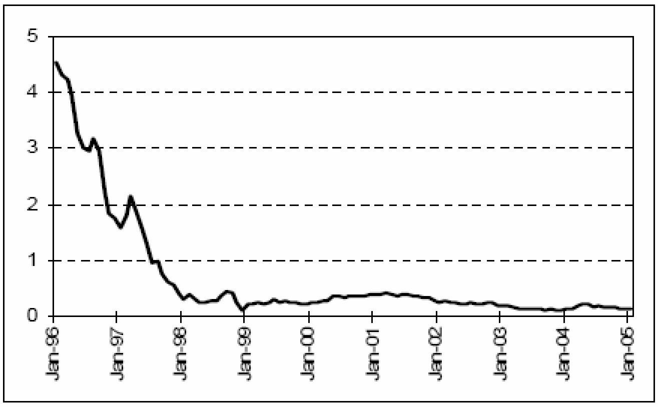
Thank you for your attention.

[5] European Commission (2005), "Working together for growth and jobs. A new start for the Lisbon Strategy", Communication to the Spring European Council, February.

EUROPEAN CENTRAL BANK

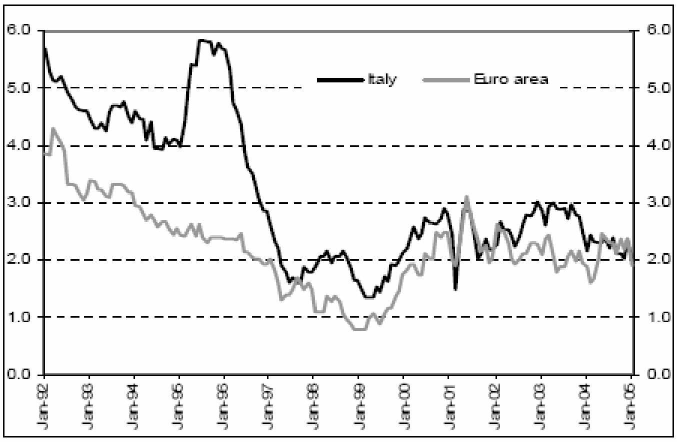
Annex to the speech "The success of the euro and its impact on European companies"

Chart 1 – Italy: Ten-year interest rate spread versus the "best performers" (pp)



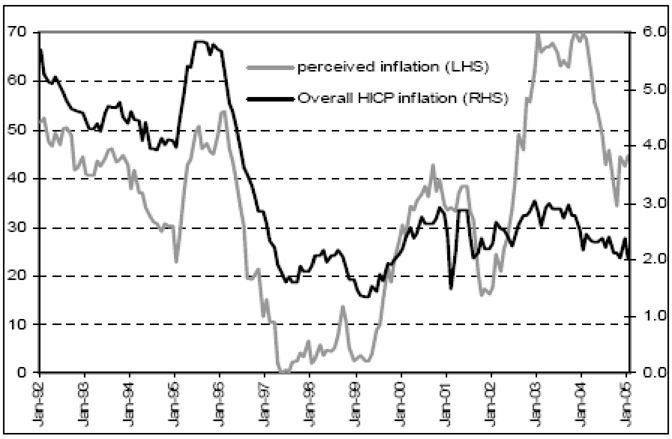
Source: Datastream

Chart 2 – HICP inflation



Source: EUROSTAT

Chart 3 - Italy: HICP inflation and perceived inflation



Source: EUROSTAT

Table 1: Real GDP growth and contribution to growth (averages over the periods)

		1994-1998	1999-2004
Real GDP growth	**Italy**	**2.0**	**1.4**
	France	2.0	2.0
	Germany	1.6	1.1
	Euro area	**2.2**	**1.8**
Domestic demand (*)	**Italy**	**1.9**	**1.8**
	France	1.5	2.2
	Germany	1.3	0.8
	Euro area	**1.9**	**1.8**
Net exports	**Italy**	**-0.3**	**-0.3**
	France	0.2	-0.1
	Germany	0.2	0.5
	Euro area	**0.0**	**0.1**

(*) Excluding stock building

Source: ECB computations on AMECO database

- Evolution of Costs, Labour Productivity, Value added and Employment in the manufacturing sector

(Cumulated growth rates, 1999-2004)

	ULC	Compensation per employee	Labour Productivity	Value added	Employment
Italy	**15.7**	**16.7**	**1.1**	**1.2**	**0.1**
Germany	-3.4	15.4	18.8	14.1	-4.7
France	1.3	15.2	13.9	7.1	-6.8
Euro area	**3.1**	**16.7**	**13.6**	**9.8**	**-3.8**
United States	**0.8**	**30.6**	**29.8**	**13.7**	**-16.1**

Source: European Commission - 2004 European Commission estimates

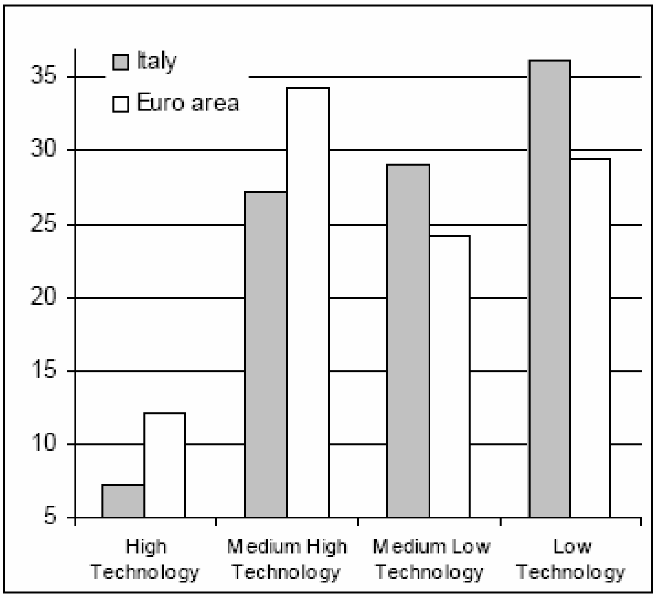
- Evolution of Costs, Labour Productivity, Value added and Employment in the total economy

(Cumulated growth rates, 1999-2004)

	ULC	Compensation per employee	Labour Productivity	real GDP	Employment
Italy	**15.3**	**14.8**	**-0.5**	**8.5**	**9.0**
Germany	3.1	8.0	4.9	7.1	2.2
France	9.4	15.1	5.7	13.4	7.7
Euro area	**10.5**	**15.1**	**4.6**	**11.2**	**6.6**
United States	**9.6**	**23.8**	**14.2**	**18.2**	**4.0**

Source: ECB and European Commission - 2004 European Commission estimates

Chart 4: Production specialisation in % of total manufacturing (year 2001)



Source: EUROSTAT

Table 3: Italy: Business Environment

	Italy	Euro area average
Cost of Starting Business (in pct per capita GDP)	16.2	11.4
Rigidity of Employment Index (1)	50	49
Legal Framework to Facilitate Lending (2)	3	5.7
Time needed to Enforce Contracts (days)	1390	183
Cost of Foreclosing a Business (pct of estate value)	18	6.5

Source : World Bank (2004), Doing Business Indicators

(1) An overall measure that captures hiring and firing costs, plus rigidity of hours worked. Higher numbers indicate a more rigid environment.

(2) Measures how well collateral and bankruptcy laws facilitate lending. Higher numbers denote a more supportive environment for granting credit

(3) Excluding Italy and, due to lack of data, Luxemburg