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

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Institute of International Finance Spring 2006 Membership Meeting, Zurich, 30 March 2006.

* * *

Ladies and gentlemen,

I am grateful to the organisers of this event (Institute of International Finance) for inviting me here today and allowing me to share with you my views on EMU and the euro. This year, the euro is in its eighth year, with a single currency and a single monetary policy for more than 300 million citizens. All in all, EMU has worked very well since its inception. Naturally, there are also significant challenges, pointing to the need for change and reform going forward. But allow me to start with the successes to date.

Successes of EMU and the euro

I would like, first, to refer to the introduction of the euro on 1 January 1999, an event of the greatest significance that has turned Western Europe into an even more economically integrated area. I will not dwell long on this, but the logistics of the cash changeover on 1 January 2002 for over 300 million European citizens represented a tremendous organisational and technical challenge. The changeover however took place in a very smooth fashion, and the euro in its physical embodiment was immediately accepted by the citizens of Europe. The transition to the new banknotes and coins was facilitated by the fact that the financial markets were already fully accustomed to the euro since January 1999. At that point in time, the introduction of the euro in book-entry form had represented another complex task that was carried out successfully and in a perfectly coordinated manner.

At the time of the introduction of the euro, a completely new monetary policy framework was introduced with the European Central Bank conducting a single, stability-oriented monetary policy for the entire euro area. However, the European Central Bank and the euro could inherit the high level of credibility achieved by the most stable national currencies and the monetary policy framework of these national central banks. The new framework, together with the convergence of general economic policies that was implemented during the run-up to the introduction of the euro, generated an environment supporting enhanced macroeconomic stability. As you know, the European Central Bank aims to maintain price stability by keeping inflation rates below, but close to, 2% over the medium term. Looking back at the period since the euro was launched, the inflation rate in the euro area was on average very close to 2%. It has occasionally risen above the 2% ceiling as a result of temporary disturbances, such as the recent hike in oil prices. However, when such shocks occur, it is important for us to ensure that price stability is maintained over the medium term. In this regard, it is worth mentioning that inflation expectations over the next 10 years (as measured in particular by Consensus Economics) have never exceeded 2% since the introduction of the euro, i.e. exactly at the level consistent with a definition of price stability – "below but close to 2%". During the last seven years, monetary policy in the euro area has been successful in maintaining stable prices, thereby making the best possible contribution it can make to sustained output growth. Along the way, stability-oriented policies have also directly improved the well-being of households, inter alia, by supporting the purchasing power of their income and savings.

Nominal and real interest rates have remained at low levels ever since the euro was introduced and are expected to stay at historically low levels over a long period of time. Looking back in time, it is interesting to note that, all along the yield curve, market interest rates in euro area countries became aligned with the lowest – instead of the average – rates prevailing prior to the euro. This low level of interest rates is of course supportive of the economic recovery in the euro area, while at the same time being consistent with price stability over the medium term. Moreover, interest rates have over time reflected a high degree of "consonance" between the European Central Bank's policy intentions and the market views concerning the course of policy. Such a level of predictability of policy, which signals a high degree of transparency, is particularly rewarding, considering that a significant part of our job is devoted to explaining and discussing our actions and our goals to the public. Transparency is a precondition for accountability and improves communication with the public regarding how the European Central Bank conducts monetary policy, thereby fostering predictability and making policy much more effective. In this regard, allow me to stress that the European Central Bank was the first major central bank to introduce a real-time press conference displaying in detail the diagnosis and the monetary policy decisions of the Governing Council.

Another important result of monetary unification is the increase in European financial integration. A large, liquid and integrated money market was created after 1 January 1999. The euro bond market quickly turned into the second largest bond market in the world. Within the euro area, the elimination of exchange rate risks and the lower transaction costs which followed have created new opportunities for businesses, thereby being conducive to a more efficient allocation of capital. As a result, European firms have attained higher levels of efficiency and competitiveness, which is by itself supportive of greater potential growth in the long term. EMU itself has contributed to further reducing financing costs owing to the lower premia associated with the increased focus on stability-oriented economic policies. The available data indicate an overall high degree of integration in the euro area money market following the introduction of the euro, as illustrated in particular by the drop to close to zero in the cross-country standard deviations of unsecured money market rates. Government bond yields have converged in all euro area countries and increasingly tend to be driven by common news. Ten-year euro area government bond yields are currently at levels significantly below 4%. Furthermore, financial deepening is evident in the rapid growth of new market segments, such as the corporate bond market, reinforcing the access of investors to funds and thereby contributing greatly to economic growth. Finally, measures of cross-country equity flows point to a rising degree of integration, with the advantages of sectoral diversification gaining ground over those of geographical diversification.

Productivity and growth

Let me now turn to the major challenges facing us. First of all, I will refer to the medium- to long-term trends for growth and productivity. If we compare growth in the US and the euro area since the mid-1990s, we find that it has been significantly higher in the former. Between 1996 and 2005, average real GDP growth per year was 3.3% in the US and 2.1% in the euro area. The difference between the growth performance in these two economies is partly related to demographic trends. However, it also stems from higher productivity growth in the US. Labour productivity growth (per hour worked) was 1.3% in the euro area during the period 1996 to 2005 compared to 2.3% in the US. Over the same period, the annual rate of increase in employment (in terms of hours worked) was around 0.8% in the euro area, which was only moderately below that in the US, at 0.9%. It is worth mentioning the euro area experienced a slowdown in labour productivity growth (per hour worked) at around year 2000, with productivity growth declining from 2.0% in 1996-2000 to 0.8% in 2000-2005 (compared with rates of 2.0% and 2.6%, respectively, in the US).

One important factor constraining euro area productivity growth has been the slowdown in capital deepening. As you know, capital deepening is the increase in the volume of capital per unit of labour input. During the last decade the contribution to growth from capital deepening in the euro area was below that observed in the early 1990s, and significantly below that in the US. At a more disaggregated level, recent studies have highlighted the role of the information and communication technology (ICT) in explaining the acceleration of productivity growth in the US in the mid-1990s. We have all witnessed the profound change of the economy in the domain of the production of goods and services that has been brought about by lower costs of computing and communicating information.

Overall, the different incorporation in the economy of the ICT revolution helps explain the diverging trends in labour productivity growth between the euro area and the US in recent years in two ways. First, we observe lower productivity growth in the ICT-using sectors in the euro area compared with the US. In particular, key ICT-using services, such as retail, wholesale and financial services, missed out to raise productivity growth in recent years in the euro area. The deceleration in labour productivity in these sectors seems primarily related to strong employment growth, which reduced the pace of capital deepening.

Second, ICT-producing sectors have made a smaller contribution to overall labour productivity growth in the euro area compared to the US (approximately 0.5 percentage points between 1996 and 2002 in the euro area, compared with 0.8 percentage points in the US during the same period). This can be in part attributed to a relatively small output share of the ICT-producing sector of 5.3% in the euro area, compared with 7.0% in the US.

The latest empirical studies have found evidence that economic growth is associated with the degree of development and structure of the financial system. Well-developed financial systems help to channel resources towards the most rewarding activities and therefore encourage the most efficient allocation of capital. A further development of the euro area financial system can be achieved via deeper financial integration. In this regard, one requirement for increased cross-border financial flows is the establishment of pan-European payment systems. The banking payment system put in operation at the same time the euro was introduced – TARGET – has successfully linked up all national payment systems and allowed settlements between financial institutions to be made gross at any time during the day. At the retail level, one prerequisite for enhanced financial integration that is still needed is the fulfilment of the single euro payments area - SEPA. The SEPA project, in which the European Central Bank acts as a helping hand, will create, out of the many different national payment schemes, an integrated scheme for each of the three main payment instruments (credit transfers, direct debits and cards). This process would also enable the consolidation of national retail infrastructures into more efficient pan-European infrastructures with competing operators.

Sound macroeconomic policies are also key to sustainable long-term growth. In particular, recent studies have emphasised the benefits of maintaining low and stable inflation and preventing unsustainable fiscal deficits and levels of debts. In this regard, a sound monetary policy is a necessary condition for sustainable economic growth and job creation. Price stability ensures the transparency of the relative price mechanism, thus enhancing the efficiency of resource allocation. High and uncertain inflation gives rise to inflation risk premia, implying that fewer investment projects will be profitable and the potential output growth rate is consequently reduced.

The need for structural reforms

Let me turn to another key challenge for the euro area, namely, to cope with accelerated globalisation. European economies and workers in particular need to be increasingly flexible to adjust to rapidly changing supply and demand conditions. The still high euro area unemployment rate of 8.6% in 2005 is the most obvious evidence for the euro area’s insufficient ability to flexibly adjust to changes in the economic environment. Against this background, urgently required are structural reforms that ease adjustment processes and that have the potential to increase both labour productivity growth as well as labour utilisation. These structural reforms must aim at what Wim Kok once summarised as “Europe needs more people in work, working more productively”. Let me briefly highlight four main areas for structural reform.

First, the euro area needs labour market reforms that increase labour utilisation by raising employment as well as working hours on a life-time basis. Looking back, progress with labour market reforms in the euro area over the last years seems to bear fruit, as indicated by the overall decline in the aggregate euro area unemployment rate from 10.5% in 1995 to 8.6% in 2005. However, particularly worrying are the still high level of the unemployment rate of young persons aged 15-24, amounting to 17.8%, and the still low rate of employment of older workers aged 55-64, standing at just 40.2% in 2005. According to the European Commission, population ageing will lead to a fall in the euro area working age population, i.e. the population aged 15-64, by 13 million between 2005 and 2030. In this context, a general improvement in the labour market position of young and older persons is of the utmost importance. To increase labour utilisation, necessary labour supply side measures include reforms of tax and benefit systems that increase incentives to work. On the labour demand side, there is a need to promote wage flexibility and to address labour market rigidities.

Second, also reforms on euro area goods and services markets have a substantial role to play in increasing employment and productivity growth. Policies improving the functioning of product markets include the extension and deepening of the EU internal market. With service-related activities representing around 70% of value added and employment in the euro area (against almost 80% in the US), more competition in EU service markets would be required. Overall, a higher competition in services markets would promote a more dynamic economy and create more jobs. Moreover, also a further opening up of network industries, representing around 9% of euro area production and 7% of euro area employment, should be beneficial for consumers as some substantial price reductions in the telecommunication sector over the last years have shown.

Third, creating an entrepreneurial-friendly economic environment with low administrative and bureaucratic costs for firms and business start-ups should help to create new jobs. To the extent that these measures increase product market competition, they should simultaneously contribute to fostering labour productivity growth. The immense importance of this issue is increasingly appreciated by European governments and several initiatives at national or EU-wide level have started to implement actions for a “better regulation”. Let me illustrate this with reference to some figures comparing the US and the euro area. Following studies by the World Bank, in 2004, the average cost of starting a business with up to 50 employees in the euro area (excluding Luxembourg) is estimated to have been around 10 times larger than in the US, amounting to roughly USD 2,700 (EUR 2,250). In 2005, it took on average 27 days to set up a business in the euro area, compared to 5 days in the US.

Fourth, further policies are required that aim more directly at raising long-term productivity growth. According to the latest available information, roughly 1.9% of euro area GDP was spent on R&D, while the corresponding fraction was around 2.6% in the US. R&D needs to be accompanied by additional efforts that aim at improving the labour force's level of education and expertise. The last decades have already brought about an enormous increase in the level of educational attainment, the so-called "catch-up effect in education". In the euro area, according to OECD data for 2003, an average of 73% of those aged 25-34 had attained at least upper secondary education, compared to only 46% of persons aged 55-64. Nevertheless, meeting the challenges of technological progress and ensuring the labour force's employability and flexibility, requires that human capital is continuously adjusted to labour market needs through improved education and training as well as lifelong learning.

Implementing this non-exhaustive list of structural policy priorities should help the euro area to increase labour productivity and labour utilisation as well as increase its overall flexibility in response to economic shocks. To properly address national reform priorities, the euro area countries will benefit from ambitiously implementing the National Reform Programmes they have set up in 2005. For the euro area countries with a single currency, open, competitive and flexible labour, product and financial markets are especially important. For firms in the euro area, structural reforms should generally lead to a greater choice between suitable investment options and open up possibilities of cost reductions, thus helping them to raise competitiveness. Within a monetary union with increased price and cost comparability it is of paramount importance that firms remain competitive by controlling domestic cost developments as captured by, for example, unit labour costs. This is exemplarily illustrated in the case of Germany which had lost competitiveness due to reunification, and which embarked on a catching up exercise between 1999 and 2005, witnessing only limited cumulated unit labour cost increases of 2.6% compared to a euro area average of 11.2%. This significant improvement of the German economy's cost competitiveness is one of the explanations for its strong export performance.

Fiscal policy

Turning to the fiscal aspects of EMU, there is no need to discuss at great length the merits of maintaining sound fiscal positions. Sound fiscal positions inspire confidence in the sustainability of fiscal policies. This reduces the uncertainty surrounding long-term economic decisions and is thus conducive to stable and sustainable growth and employment. The importance of maintaining sound fiscal positions becomes even greater in a monetary union. In such an environment, the costs of fiscal profligacy to the individual government are reduced as negative implications for the interest rate are distributed across the entire union. In addition, exchange rate variations do not provide signals regarding investor confidence in the domestic economy any more.

The EU fiscal framework, as laid down in the Maastricht Treaty and the Stability and Growth Pact, ensures that fiscal discipline is maintained in EMU. The Pact provides a system for the monitoring of fiscal policies and, if necessary, the timely correction of excessive deficits.

Overall, the fiscal policy framework was successful in reducing average fiscal deficits in the euro area and halting the trend increase in the debt ratio. At the beginning of the 1990s, most euro area countries showed sizeable imbalances in their public finances, with the average deficit reaching 5% of GDP and more. In the run-up to monetary union, fiscal balances improved substantially: the euro area average deficit ratio declined to 2.6% in 1997, the reference year for the decision on which countries were to join the common currency from its start in 1999. Since then, fiscal deficits have first improved before consolidation fatigue set in. Some countries incurred deficits in excess of the 3% of GDP reference value, in some instances even substantially above the threshold. Nevertheless, the euro area average deficit ratio has remained below the values recorded in the 1980s and 1990s. As a consequence, the long-run increasing trend in the debt ratio, which more than doubled between 1980 (34.2%) and 1997 (74.7%) has been halted.

Nonetheless, further reforms in the fiscal area are needed. Let me mention three major challenges: i) a number of governments still need to correct large fiscal imbalances and improve the structure of public finances; ii) national institutions for fiscal policy making should support the fiscal commitments under the EU framework and iii) governments must prepare for the fiscal burden arising from demographic ageing.

Regarding the first challenge, countries with large imbalances must correct them in line with commitments under the Pact and country-specific ECOFIN Council recommendations. This will ensure the soundness of national fiscal positions and strengthen the confidence of households and investors in the sustainability of economic policies. Beyond this immediate requirement, most euro area countries are in need of a comprehensive and growth-friendly reform strategy, which must include the pursuit of fiscal consolidation. Structural expenditure reforms are essential for healthy and growth-promoting public finances. To help promote investment, innovation and employment, expenditure needs to be directed towards productive goals. But, in many cases, it will also be essential to review government commitments, especially their less productive elements.

Turning to the second challenge, the current very high expenditure shares may also be a reflection of the way in which fiscal policy frameworks operate at the national level. The experience shows that some euro area countries have managed to translate the constraints under the EU fiscal framework effectively into their domestic fiscal policy institutions. As a consequence, these countries find it much easier to comply with the requirements while maintaining sole responsibility for their policies. To ensure fiscal soundness over the medium and long term, euro area countries should have fiscal policy arrangements that ensure consistency with the requirements of the EU framework.

Finally, in the long run, population ageing will put a substantial burden on public finances. This will occur directly through the impact on public pension and health care expenditure as well as via the growth-dampening effects of a gradually shrinking share of the labour force in the population. Public expenditure increases of up to 10% of GDP have been projected if no action is taken. Governments need to prepare for this burden before expenditure pressures start to increase rapidly after 2010. In many countries, this requires reducing current debt ratios and reforming public pension and health care systems. In addition, reforms are needed that lead to higher labour market participation and lower unemployment. Only if these reforms are implemented swiftly can we cope with population ageing, maintaining sustainable fiscal positions, a reasonable tax burden and sustained growth.

Conclusions

Let me conclude by stressing that the euro has been firmly and credibly established as a stable currency. The euro has brought a period of currency stability, low rates of inflation, low levels of medium- and long-term market interest rates, and higher economic integration via enhanced trade and financial interdependence. I hope, however, that I have not communicated a sense of complacency over past achievements. At the European Central Bank we must continue to comply with our mandate of maintaining price stability and, through this, contribute to a macroeconomic environment supportive of economic growth. The challenges ahead of us are a reminder that European integration is a dynamic process and that it will bring about deeper structural transformations. As a matter of fact, the historical process of European integration is moving steadily forward and will require our utmost effort and commitment for years to come.

Thank you very much for your attention.