

Christian Noyer: Building on Euro area achievements to prepare for enlargement

Speech by Mr Christian Noyer, Governor of the Bank of France, at the 2007 Annual Conference on Macroeconomic and Economic Policy Issues, Bank of Latvia, Riga, 10 October 2007.

* * *

Ladies and gentlemen,

It is a great pleasure and honour for me to address this conference hosted by the Latvijas Banka.

Having just passed the European Union 50th anniversary, it is an appropriate time to reflect upon the essence and future of this extraordinary endeavour. Never before, in the whole history of mankind, have democratic nations pursued and reached, through peaceful cooperation, such a close degree of interdependence, involving, in many crucial areas, deliberate pooling of sovereignty. Of course, the process has not been without difficulties and tensions, many of which are still apparent and acute. Of course, numerous challenges remain. But, for the first time in more than a thousand years, Europe is at peace and prosperous, with democratic regimes everywhere. This is, by historical standards, an exceptional achievement.

The whole process of European integration was based on a strong intuition: by sharing the instruments and policies underpinning economic prosperity, European nations would create an irreversible situation of interdependence and solidarity where conflicts and wars of the past would become impossible. The creation of the Euro area is the natural consequence of this original intuition. It results both from a political vision and an economic and financial necessity. The process of monetary cooperation was launched as a response to the potential financial and economic instability stemming from the collapse of the Bretton Woods system. It met with many obstacles and went through several crises. At some point, it came close to being abandoned altogether. But today, the Euro is alive and well: since 2002, it has been the sole currency with legal tender in all countries of the Euro area, providing more than 300 million of European citizens with a new, practical unifying symbol as well as many direct economic benefits.

Before addressing the Euro area enlargement issues let me first elaborate on the successes and challenges of monetary integration in Europe. Enlargement should both preserve these successes and help handling the challenges.

The first, and most obvious achievement of the Euro, is price stability. Over the last five years, inflation has stayed broadly in line with the price stability objective set by the European Central Bank, i.e. inflation below but close to 2% over the medium-term. Gone are the days when European citizens had to worry about the purchasing power of their savings. This stability goes beyond the behaviour of prices. Inflation expectations themselves have been remarkably stable, including during the recent period when oil prices jumped to new highs. This, by itself, illustrates the credibility achieved by the Eurosystem.

Second, the ECB's clear priority of price stability has reduced the risk premium incorporated in long term interest rates. Bond yields have, consequently, been low by historical standards, a phenomenon which has substantially facilitated private investment. This in turn, will not fail to have a highly positive effect on growth.

A third benefit of the Euro is the removal of exchange rate risk and transaction costs for intra Euro area trade. This has promoted trade integration among Euro area countries without diverting trade with other countries. Indeed, it appears that business cycles tend to be more and more synchronized over time, an evolution which allows for greater efficiency and

sustainability of the common monetary policy. This shows that monetary union is a self sustaining process: real convergence is to some extent a result, as much as a precondition of economic integration.

Another benefit of the Euro is the boost it gives to financial integration in Europe. In many segments, European financial markets have reached the depth and liquidity which, up to now, were the preserve of dollar markets. This stimulates productive investment, helps in restructuring and, more generally, allows a better allocation of savings and sharing of risks. The current market turmoil is a clear test for this achievement and while the problems affecting the Euro markets have been comparable to those affecting the other major markets, the strength of the Euro shows, to some extent, that it has become a safe haven in our globalized financial world.

The Euro is becoming extremely attractive, as a vehicle, a transaction, an investment and a reserve currency. As you may know, as central bankers, we remain neutral as far as the internationalisation of the Euro is concerned. We are neither encouraging, nor discouraging the process. But, as a citizen, I cannot help and feel proud of having one of the two main currencies in the world.

These achievements are the fruits of a long term process of reforms and credibility building, but they are not carved in marble. Looking at the many challenges we are facing we could even wonder if monetary integration is really sustainable in the long run. My answer is positive and I am strongly optimistic about the future for the Euro, because we have a clear agenda in order to handle these new challenges.

A first challenge is related to globalisation that exerts pressure on industrialised countries as the competition of new players in the global market increases. In that context, the rapid and thorough implementation of the Lisbon agenda is essential, since it will pave the way to a knowledge-based economy and hence improve Europe's competitiveness.

A second challenge is related to current account imbalances in some member states: the disconnection between national saving and investment is welcome to the extent that it facilitates a more efficient allocation of capital. But persistent imbalances may reveal competitiveness problems. Since deficit countries can no longer make use of devaluations to improve their competitiveness, as they sometimes did in the past, they need to improve the whole structure of their economies. And if one member of the monetary union improves his competitiveness through structural reforms, the others have to follow through. This process may lead to a "virtuous cycle" of reforms improving the whole competitiveness of the Euro area.

The ageing of Europe's population is another important common challenge faced by all industrialised countries but which is especially affecting our continent. In that context, it is all the more essential to address current fiscal imbalances before the budgetary impact of ageing sets in. This will need to be done through continuing efforts to reform the welfare state – notably by enhancing its efficiency and effectiveness. Reforms should not merely aim at overhauling our countries pension systems, but might also be directed towards increasing labour force participation rates.

These new challenges require appropriate macroeconomic policies and further broad structural reforms, some of which have been already engaged in most countries.

Confronted with major trends in demographics and global economic integration, the overriding goal of policymakers should be to strengthen the resilience of our economies to shocks.

Further reforms remain to be undertaken in order to improve the smooth operation of goods and labour markets. In both cases, ill-conceived protection mechanisms have often turned into rigidities that hold back growth. Indeed, reaching a high growth potential in knowledge-based economies requires new forms of flexibility and enhanced adaptability:

- In goods markets, monopolistic rents, which are rarely justified, should be reduced, hence favouring R&D, free entry and exit.
- On the labour market, reforms should aim at protecting the persons, rather than the jobs. Professional mobility can be accompanied without blocking changes, while further progress can be made at improving risk sharing among employers and employees and fostering education.

The gains from taking such steps are only reaped in the long run, while the costs are paid in the short run. In addition the gains can be seen as small from an individual point of view because widespread across a large number of agents, while the costs are more visible, concentrated on fewer beneficiaries who lose their position. This means that the reforms have to be well explained and well designed.

Besides, a healthy public finance situation is seen as one of the prerequisites for the success of structural reforms: the degrees of freedom are also limited in that respect. In this regard, modernising public administrations can be a key element to ensure control over expenditure and budgetary consolidation.

Appropriate monetary policy has a limited, although essential, role, insofar as it can help create favourable conditions for reform by insuring a stable price environment and therefore reducing overall uncertainty.

Taking into account the achievements and the prospects for further reform in the present Euro area, what are the challenges facing the New Member States in the process of convergence and what are the prospects for a successful Euro area integration?

In contrast with some gloomy predictions made ten years ago, the Euro is a success story. Far from being a closed Club, the Euro area is open and has a true calling for covering all the EU members, in so far as they fulfil the convergence criteria. Indeed, adopting the Euro can be seen as a legal obligation for all EU members once they have fulfilled the Maastricht convergence criteria.

Monetary union is an on-going process. Starting in 1999 with 11 members, the Euro area has regularly expanded. On the 1st of January 2001, Greece joined the Euro area. More recently, on the 1st of January 2007, Slovenia was the first of the New Members States which entered into the EU since 2004 to adopt the Euro; this brought the current number of members of the Euro area to 13. Two more NMS – Cyprus and Malta – will join the monetary union in 2008.

At this stage, the relevant question for the new EU member states is thus not whether but when to join the Euro area. The answer of this question is clear: the New Members States have to achieve strict and sustainable fulfilment of the Maastricht criteria whose economic rationale is very strong.

Why strict and sustainable? I see three main reasons:

- not only to guarantee the credibility of the Euro (which is, in itself, in the interest of entrant countries themselves who will adopt this currency as their own);
- but also to ensure equality of treatment between all entrants, who have to be applied, over time, the same entry criteria;
- and, last but not least, to avoid the emergence of disequilibria after entry requiring painful adjustments, as shown by the Portuguese situation. Sound macroeconomic conditions have to be guaranteed before and after accession. Joining the Euro area does not guarantee convergence in development levels. National institutions and policy remain crucial after entry.

The Maastricht criteria encompass: limited inflation differential vis-à-vis the best performing EU member; stability of the nominal exchange rate with the Euro; sound fiscal accounts; and low long term interest rate spread vis-à-vis the best performing EU member states in terms of price stability.

They must be satisfied simultaneously for a country to be able to join the EMU. Regarding participation in the ERM II, it is not a mere two-year “waiting room” before the Euro. It is a “training room” for full implementation and assimilation, by all economic agents, of sound policies. Therefore the criteria defined in the Treaty must be fulfilled, not just once, but with a good track record and with good prospects. In this regard, entrant countries should pay specific attention to their current account deficits, which are referred to in the Protocol on the convergence criteria, because they have to be sustainable in order to ensure a smooth stay in ERM II and a good competitive position later in the monetary union.

The economic rationale of the criteria is clear: membership of a monetary union entails abandoning monetary policy as a country specific adjustment tool. Diverging inflation rates become quickly unsustainable both because they create strong real exchange rates movements within the area and different real interest rates at the national level. In this context more inflation-prone countries would have too low real interest rates leading eventually to credit booms, domestic demand overheating, and loss in competitiveness and external deficits. Furthermore, in the absence of an independent monetary policy at the national level, fiscal policy becomes the main adjustment tool. In this context, fiscal criteria were designed in order to assess the ability of the government to conduct sound fiscal policies.

Achieving strict and sustainable fulfilment of the Maastricht criteria involves in my view three elements. Sound fiscal and monetary policies are the minimum requirement in order to meet the nominal criteria. However, meeting the nominal criteria is not sufficient to assess that the economy of the candidate country is ready for monetary integration.

The second element, a sufficient advancement in the process of real convergence, is related to the assessment of sustainability. It results from standard economic analysis that fast growing economies require a higher level of real interest rates to remain on a sustainable path. Monetary policy in the Euro area is designed for advanced economies and would be inappropriate for less developed economies. Indeed, a premature entry would imply a downward shock on interest rates and other policy parameters such as reserve ratios. This would generate supply/demand imbalances, credit booms and asset or consumer prices inflation resulting in financial vulnerabilities and deteriorating competitiveness.

It should come as no surprise that the third element relates again to the advancement in structural reforms: these are preconditions for ensuring viable economic development inside a monetary union. Such reforms are necessary in order to enhance flexibility, thus giving the economy the necessary adjustment capacity required in a monetary union. The key role of structural policies naturally includes the conduct of fiscal policy reforms (tax, pensions, and social security) and investments in public goods (infrastructure, education, healthcare, etc.) that have to be completed before entry in order to provide enough leeway for fiscal policy to serve as a stabilisation instrument inside the monetary union.

The New Member States that have joined the EU since 2004 have made considerable progress in nominal and real convergence. Recovering from historic episodes of economic contraction, hyperinflation and exchange rate depreciation, these economies have recorded gradual macroeconomic stabilisation characterised by disinflation, high rates of GDP growth and real exchange rate appreciation. Sound macroeconomic policies, institutional improvements spurred by EU-accession, increased trade and financial integration with the EU contributed to a rapid catching-up. Indeed, the year 2006 was the year with the highest GDP growth for the region since the beginning of transition.

Today, the New Member States face the challenge of maintaining stability and sustainability of the catching-up path. Stability requires macroeconomic policies avoiding the accumulation of imbalances. Sustainability implies that past rates of high economic growth could be maintained in the future. To some extent, economic performance in the past decade could partly be related to a cyclical recovery after an initial slump. The recent dynamics were also generated by the massive reorganisation and privatisation of the economy after the fall of

communism. This process triggered large FDI inflows providing both financial means and technological transfer. Today privatisation is almost complete and one has to look for new engines pushing forward the catching-up process.

Currently, I see three main risks that have to be addressed as priorities by policy-makers:

- (i) increased financial vulnerabilities, in relation with fast credit growth and mounting external imbalances ;
- (ii) rising inflation pressures which hurt external competitiveness; and
- (iii) the challenge of ensuring high future potential growth. .

This third challenge belongs to the long-run as future economic developments will need to feed productivity growth beyond the dynamics of catching-up, through technological and production process innovation. It is however a present concern to the extent that recent signs of increasing labour market shortages and decreasing FDI inflows question the capacity to maintain GDP growth at the high levels recorded in the past.

Addressing these risks and challenges will require the conduct of prudent macroeconomic policies insuring short-term stabilisation, with fiscal authorities avoiding pro-cyclical loosening and generous spending policies, and monetary authorities preserving price stability and guaranteeing financial stability. However, macroeconomic policies alone are not sufficient to improve the long-term growth potential: they are aimed at fostering a stable and transparent business environment, but have to be supplemented by the implementation of structural policies designed to enhance labour market participation, labour mobility, competition in goods market, investment in education, R&D and infrastructure.

It appears very clearly that the challenge of a stable and sustainable path for the catching-up process is closely interlinked with the challenge of a successful integration in the Euro area. For that purpose, it is in the interest of the New Member States themselves to be patient while accelerating structural reforms in order to meet both these challenges. Euro area accession will come in due course as the well deserved reward for the efforts of each country in creating the conditions of its own long-term economic prosperity. I look forward to such accessions.