Jean-Claude Trichet: The current state of the euro area and its future

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference "The euro's 10th anniversary: history and presence of the euro", Munich, 10 July 2008.

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Meine Damen und Herren,

es ist mir eine große Ehre und Freude, hier am heutigen Tag über den Euroraum in seiner derzeitigen Form und in der Zukunft sprechen zu dürfen. Noch vor wenigen Jahrzehnten wäre eine einheitliche Währung in Europa für viele Beobachter undenkbar gewesen. Und doch feierten wir, wie Sie wissen, vor Kurzem das zehnjährige Bestehen der EZB und somit auch des ESZB, des Europäischen Systems der Zentralbanken. Seit der Einführung des Euro im Januar 1999 konzentriert sich die EZB auf die Gewährleistung der Preisstabilität im Euroraum, ihr vorrangiges Ziel.

Ladies and gentlemen,

It is a great honour and a pleasure to be invited here today to speak about the current state of the euro area and its future. Not many decades ago, a single currency in Europe would have been unthinkable for many observers. And yet, as you know, we have just celebrated the tenth anniversary of the creation of the ECB and, for that matter, the ESCB – the European System of Central Banks. Since the launch of the euro in January 1999, the ECB has focused on preserving price stability in the euro area, its primary objective.

You all know very well that inflation rates have continued to rise since the autumn of last year. Inflation is expected to remain above the level consistent with price stability for longer than we previously thought. Last week we had to act to discourage second-round effects and to counteract the increasing upside risks to price stability over the medium term. Our decision will contribute to delivering price stability over the medium term. As I will argue in my talk today, a lot depends on the solidly anchoring of inflation expectations.

Over the last ten years, the ECB has gained a great deal of respect and credibility. Since the launch of the euro, the average inflation rate has been just slightly above 2%. And this has been achieved, despite various shocks that have hit the euro area over these years, including the ongoing strong global increase in commodity prices that is affecting Europe and the rest of the world. In the decades before the launch of the euro, average annual inflation rates in many EU Member States were very significantly higher. This is a remarkable result. It shows that we have inherited the credibility that was the privilege of the most successful currencies before the euro.

Today, I would like to share with you some of our achievements over these past ten momentous years. They call for celebration. But over and beyond our performance in terms of price stability, I would also like to share with you reflections on the economic performance of the euro area and some of the remaining challenges that the ECB and the euro area as a whole face as they enter their second decade. I will then make a few remarks on the sound economic management of our Monetary Union.

1. On the achievements of the euro area

The new monetary policy framework – with the ECB setting the monetary policy for the entire euro area – was quickly understood and trusted from the very first days. The ECB has a clear mandate – to safeguard price stability in the euro area – and is independent. In 2003, the ECB clarified that price stability meant maintaining inflation rates close to and below 2% over the medium term. This is a clear yardstick against which the public can judge us. While being custodian of the trust of the citizens of the euro area, we are also fully accountable to them, and endeavour to explain our actions. Over these ten years, this framework has contributed to anchoring longer-term inflation expectations.

We all know that price stability is essential for the success of a large economic and monetary union. It protects the incomes of all of us, and particularly those of the most vulnerable and poorest of our fellow citizens. An aspect that is often neglected is that, thanks to price stability, diverse other benefits follow. Price stability is a precondition for sustainable growth and job creation and, ultimately, social cohesion.[1] It is also a major contribution for financial stability.

The euro also promotes the functioning of our vast continental market and, therefore, helps bring about a true single market for goods, services, capital and labour. During the first nine years of the euro, 15.7 million new jobs were created in the euro area, and the unemployment rate is now at the lowest level since the early 1980s. Our common currency has also helped to protect the euro area economy from diverse global shocks, as well as from the considerable turbulence of the last few years. Let me offer you two examples of the credibility of the ECB and the benefits that this brings.

- Over recent months, we have seen that actual inflation may temporarily diverge from our medium-term objective. The ***first example*** of the credibility of the ECB is that long-term inflation expectations have remained solidly anchored. In fact, they have remained well anchored over the entire ten years. This is remarkable considering the series of adverse economic disturbances that have hit the euro area since its inception.
- The ***second example*** of the credibility of the ECB is that medium and long-term market rates of the euro are at the same low levels in terms of embedded inflation expectations and risk premia as those experienced by the most stable national currencies prior to it. In other words, we have been instrumental in securing the lowest market interest rates on a 5, 10 up to 50-year basis. Most euro area countries have benefited from significantly better financing conditions than in the 1990s, a situation which has also supported fiscal consolidation.[2]

The euro has also helped strengthen trade and financial linkages across euro area countries. There is clear evidence that the introduction of the single currency and the associated increase in price and cost transparency have fostered both intra and extra-euro area trade in goods and services. In fact, the sum of intra-euro area exports and imports increased from about 31% of GDP in 1998 to around 40% in 2007 – approximately 9 percentage points. During the same period, extra-euro area trade growth even exceeded that in intra-euro area trade, rising 13 percentage points from 31% to 44% of GDP in 2007. Hence, there is no "fortress Europe".

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1 Several studies have shown how harmful inflation (and inflation volatility) can be. Let me also remind you that empirical evidence shows there is a negative relationship between inflation and output growth, with a 100-basis point permanent increase in inflation being associated with a 10 to 30-basis point decrease in trend output growth (see the May 2008 issue of the ECB's Monthly Bulletin).

2 After the transition to the euro, the yield curve was fully in line with the benchmark set by the most credible currencies before EMU. As a result, in some euro area countries, medium and long-term market interest rates fell to unprecedented levels when the euro was introduced and have remained there since. This is a phenomenal benefit. In fact, most euro area countries have benefited from significantly better financing conditions than in the 1990s, a situation that has supported fiscal consolidation. For instance, in the run-up to Stage Three of EMU, fiscal deficits were reduced considerably, mainly on account of falling interest payments, from an average of 5.2% of GDP between 1990 and 1998 to 3.4% between 1999 and 2007 (see ECB, "10th Anniversary of the ECB", Special Edition of the ECB's Monthly Bulletin, June 2008).

Let me also mention that, when I travel around Europe, I feel that a shift in mindset is gradually taking place. In fact, ***firms*** are becoming more conscious of the euro area dimension of their actions and decisions. ***Households*** are increasingly conscious of the opportunities offered by an expanded economic and financial area.

The launch of the euro has also coincided with a remarkable deepening of financial integration. The financial landscape has already changed a great deal in most market segments, and is continuing to change. The euro is acting as a catalyst for a gradual portfolio reallocation away from holdings of domestic financial instruments towards holdings of financial instruments issued elsewhere within the euro area. For instance, euro area cross-border holdings of long-term debt securities have increased strongly – from about 10% of total stocks at the end of the 1990s to nearly 60% in 2006. Furthermore, euro area residents almost doubled the amount of cross-border holdings of equity issued by euro area residents, from 15% to 29%, between 1997 and 2006, in particular on account of institutional investors. As for capital flows, the euro has boosted foreign direct investment – particularly cross-border mergers and acquisitions in manufacturing – and portfolio flows across euro area countries.

Well-integrated financial markets and diversified portfolios reduce the extent to which the saving and spending decisions of firms and households are dependent on economic and financial developments in a specific country, region or sector. As a result, credit and risk-sharing channels are increasingly helping to attenuate the impact of shocks in a specific euro area country or sector.

Let me mention also one important aspect. We live in an era of rapid technological progress. Competitive forces are reshaping global manufacturing, the financial landscape and the sharing of wealth. Large demographic changes are also under way. The impact of these "mega-trends" is very substantial, although it is difficult to quantify them precisely.

In my view, the euro area as a whole has exhibited resilience to such external developments. It is, as a whole, significantly more resilient than many of its individual member countries were before the launch of the euro.[3] The euro area has been a source of stability.

In short, the current state of the euro area is one of increasing interdependence and ongoing integration. Over these ten years, we have observed greater price stability, greater macroeconomic stability, as well as increasing economic and financial integration. However, despite these achievements, there is no room for complacency, and a great deal still needs to be accomplished.

I now want to put forward the argument that several changes in this second decade and beyond will have to come from the **"E"** in **EMU**: namely that there is a need for further substantial efforts and reforms on the economic side. In other words, I argue that there is a need for a sound economic management. This has two facets. The first is that the overall level of economic performance in the euro area needs to improve. Think, for example, of the question as to *how the euro area as a whole might raise its potential growth…and actually grow at such a higher level.* The second facet is that we need to understand and address diversity of economic performance across the euro area. Think, for example, of the question as to *the extent to which euro area countries differ in terms of economic performance.* I will deal with these aspects in turn.

[3] Not so long ago, the impact of movements of the Deutsche Mark against the US dollar was often aggravated by similar movements between the currencies that have now been replaced by the euro. This can no longer happen. This increasing resilience is illustrated by the fact that the major shocks of the last ten years have not played an important role in the dispersion of output growth. In other words, they have not contributed to the economic diversity that I will now go on to discuss.

2. On the economic performance of the euro area

The achievements I have just described have accompanied an impressive performance in terms of job creation. From the start of EMU to the end of last year, as I have already mentioned, the number of people in employment in the euro area has increased by 15.7 million, compared with an increase of only some 5 million in the previous nine years, and the euro area unemployment rate has fallen to its lowest level since the early 1980s. Of course, the surge in employment cannot be attributed solely to the euro. It also reflects corporate restructuring, the progress made on structural reforms and overall wage moderation in most countries.

However, Europe is far from having exhausted its potential for further increases in labour participation rates and employment. Let me flag just a few facts. The overall employment rate in the euro area remains modest by international standards – 65.7% in the euro area, compared with 72% in the United States – and the unemployment rate is still clearly too high – over 7% in the euro area. More specifically, while the employment rate of prime-age men in the euro area is comparable with that in the United States, considerable disparities remain when we look at employment rates among the young, among women and among older workers.[4]

Labour market reforms appear to be even more appropriate if we consider that growth performance will increasingly be constrained by relatively low population growth rates and population ageing. Since the early 1990s, the population of the euro area has been growing at a yearly rate of only 0.4%, compared with 1.1% in the United States.

Europe has room to develop its growth potential. Since the early 1990s, real GDP has grown, on average, by 2.1% in the euro area, compared with 2.8% in the United States. Since the start of EMU, the annual growth rate for the euro area has averaged 2.2% per year, compared with 2.7% in the United States. Even if one has to recognise that the euro area did slightly better than the US in terms of GDP growth per capita, it remains that the euro area's potential output growth has moved to the lower bound of its previously estimated range of 2-2.5%. A low trend growth in labour productivity explains, in large part, the modest growth performance. During the 1980s, hourly labour productivity in the euro area grew, on average, by 2.3%, while it declined to 1.8% in the 1990s and decreased further to 1.2% between 1999 and 2007. By contrast, hourly labour productivity growth in the United States accelerated from 1.2% to 1.6% and then to 2.1% over the same periods.[5]

What can be done to enhance labour productivity? In recent years, we have seen rising levels of employment, particularly in the unskilled segment of the labour market. This has certainly contributed to the slowdown in labour productivity growth. However, to a large extent, there has also been a significant slowdown in total factor productivity (TFP) growth. TFP growth is generally taken as a measure of technological progress and improvement in the organisation and overall efficiency of production.[6] There are many factors behind the low

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[4] In 2007, for instance, the female employment rate was 58% in the euro area, compared with 66% in the United States in 2006; among older workers, it was 43.3%, compared with 61.7% in the United States in 2006, while the youth employment rate was 38%, compared with 54.2% in the United States in 2006. In the case of the euro area, these features appear to be consistent with an "insider-outsider" characterisation of the European labour market, where structural impediments resulting from the legal and regulatory environment, high taxes on labour and rigidities associated with wage regulations may prevent those groups "at the margin" from actively participating in the labour market.

[5] Euro area data on hours worked per worker in 2007 are assumed to be constant. US data on hours worked per worker are estimated using OECD data for 2006 and 2007. The source of the data is the AMECO database.

[6] According to the European Commission, total factor productivity grew, on average, by 1.6% in the 1980s, before falling to 1.1% in the 1990s and to 0.7% between 1999 and 2007. The countries that have managed to exploit the efficiency gains resulting, in particular, from new technology have enjoyed stronger labour productivity growth. For instance, in the last ten years, investment in information and communication

growth in TFP. Unfortunately, most European economies do not incorporate appropriate incentives to invest in real and human capital, to innovate and raise the flexibility and adaptability of firms when their environment changes.[7]

To sum up, the remarkable labour market performance observed in the euro area since its creation could even be improved upon. Rising productivity must also contribute to enhancing the overall economic performance of the euro area as a whole. While the ECB sets monetary policy by looking at the performance of the euro area as a whole, the ECB also follows closely what happens in all euro area countries. In other words, we also look at diversity of economic performance across the euro area.

3. Diversity in EMU

Some diversity – in economic and financial developments – is a natural phenomenon in any vast currency area.[8] Rates of economic growth, inflation and changes in labour costs can differ across countries for various reasons. Some of these reasons may have no link whatsoever with monetary policy or a single currency. For instance, diversity might originate from country-specific demographic trends or from their catching-up in terms of living standards. There could also be national differences in areas such as industry characteristics, investment in research and development (R&D), and innovation. Differences in the timing and extent of past structural reforms in euro area countries are also a source of diversity.[9]

Differences in fiscal policies and other national policies can also give rise to diverse economic situations. There is an additional source of diversity due to the one-off shock constituted by the launch of the euro that may currently be working its way through the system. Some countries suddenly benefited from lower short and long-term interest rates, as well as from easier access to more competitive credit markets. This encouraged the purchase of durable and non-durable goods, as well as housing, albeit to differing extents, in the various euro area countries.

But let's put diversity in perspective. Over these ten years, the degree of diversity observed in the euro area at each point in time did not appear to be substantially different from that seen in the United States. Nor is it substantially different from that seen within the national borders of some large economies (such as Germany, Italy and Spain). However, a distinct feature of diversity in the euro area is its persistence over long periods of time. In other words, diversity in most euro area countries displays significant inertia. Let me briefly look at three types of diversity.

a) **Inflation dispersion in the euro area** declined considerably in the 1980s and 1990s and is now on a par with inflation dispersion in the United States. To give you an example, the unweighted standard deviation of annual HICP inflation rates still stood at around 6 percentage points in late 1990, but – since the launch of the euro

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technology in the United States was double that of the euro area. According to the EUKLEMS database, the average contribution from ICT capital to total economic growth in the euro area was 0.4 percentage point over the period 1995-2005, while in the United States it averaged 0.8 percentage point over this same period.

7 It appears that the structural characteristics of the best-performing industrialised economies, namely more flexible labour markets, greater competition in product markets and lower barriers to entry for new firms have been more receptive to the opportunities provided by new technologies.

8 Diversity is sometimes referred to as heterogeneity or divergences: in my view, diversity might be more appropriate in most cases because a significant degree of dispersion looks like not a defect but a fundamental feature of any vast continental economy like the US or the euro area.

9 An example of this is the Netherlands, which undertook labour market reforms far earlier than the largest euro area countries. This enhanced the country's flexibility and increased its ability to adjust to a wide range of shocks. In other countries, short-term shocks may have had more persistent effects on growth differentials owing to slow adjustment processes caused by the presence of structural rigidities.

– this rate has broadly stabilised at around 1 percentage point. This dispersion level is similar to that of the 14 US metropolitan statistical areas, but is somewhat higher than that of the four US census regions. Hence, impressive progress has been made, and I would argue that, prima facie, inflation dispersion in the euro area is not high by international standards.

However, inflation differentials in the euro area are very persistent; in this respect, the euro area does indeed differ from the United States. Most euro area countries that have exhibited higher than average inflation rates in recent years have been in this position for at least a decade. These include Spain and Greece. Similar persistence – but on the opposite side – is observed in low-inflation countries such as Germany. Only in some euro area countries, such as Portugal and the Netherlands, have differentials moved from being relatively high to being in line with – or even below – the euro area average. Such corrections are welcome, but the point is that they are slow to materialise.

If we look at the cost side, the factors generating inflation differentials are, in most countries, primarily domestic rather than external. In particular, we have witnessed sustained divergence in wage developments across the euro area and smaller differences in labour productivity growth. These differences in the growth of labour costs have been the main sources of persistence in inflation differentials. Various reasons can be suggested for this. Varying levels of wage rigidity across the euro area, changes in profit margins, imperfect competition and associated price rigidities across countries all affect labour costs and contribute to inflation differentials.

If we look at product groups, price dispersion has been greater in the field of services, mostly owing to the dispersion observed in wage developments across countries. By contrast, inflation dispersion has been relatively low for tradable non-energy industrial goods, with greater competition in tradable goods being the main reason for this. Products with relatively volatile prices (such as energy and food) have, on the other hand, shown high levels of dispersion across countries in terms of price changes.

b) **Output growth differentials in the euro area** have remained broadly stable since the early 1970s. No signs of increased annual divergence were observed between 1999 and 2007. The average dispersion of annual real GDP growth over this period (measured as the unweighted standard deviation) was around 2 percentage points. This figure is very close to the average dispersion of real growth rates since the 1980s. By comparison, if we look across all 50 US States, the dispersion of real growth has averaged approximately 2.5 percentage points over the last 15 years. When the United States is divided into the eight statistical regions, the average dispersion shrinks to around 1.5 percentage points.

One issue of concern, however, is the fact that within the euro area there is also a relatively high degree of persistence regarding output growth differentials. This is less the case in the United States. However, taking the United States as a benchmark only helps up to a point. On the one hand, the US economy is known to be more flexible than the euro area, which means that the effects of asymmetric shocks can be absorbed more easily and more quickly. On the other hand, the United States exhibits stronger regional specialisation than the euro area, making its regions more susceptible to specific asymmetric shocks.

Let me now turn to the two main drivers of growth differentials in the euro area: differentials in cycles and differentials in trends. **Differentials in cycles** have declined steadily since the early 1990s. There is also evidence of a stronger common euro area cycle accounting for a large part of the business cycle fluctuations across euro area countries. Since 1999, several shocks have spread in similar ways across euro area countries. For example, the euro area has successfully weathered several shocks, including the bursting of the dotcom bubble, the ripple effects of the terrorist attacks of September 11, the surge in global commodity prices – particularly energy prices – and the persistence of sizeable global imbalances. The high degree of synchronisation in the business cycles of euro area countries is a feature unique to the euro area. This suggests that EU integration and, more recently, the launch of the euro – rather than global forces – have led to smaller differences in output gaps among euro area countries.

The picture for the second driver of dispersion – namely **differentials in trends** – shows more lasting differences since the beginning of the 1990s, with a gradual increase in trend growth dispersion. This picture also differs across euro area countries, some of which persistently exhibit trend output growth either above or below the euro area average. It is here that the various sources of diversity that I have mentioned play a role.

c) **Changes in cost and price competitiveness** mainly reflect changes in relative unit labour costs and persistent inflation differentials. These demonstrate that there is significant leeway for influencing competitiveness, even in the absence of nominal exchange rate adjustments. To give you an idea of the magnitude of this leeway, if we consider the cumulative growth of unit labour costs for the economy as a whole between 1999 and 2007, the difference between the countries with the largest increases and those with the smallest increases was around 20 to 30%. This is an important phenomenon, and a close examination of the driving factors is therefore required.

Germany, for example, has seen moderate growth in unit labour costs over an extended period, leading to a correction of the losses in competitiveness that arose in the aftermath of German reunification. This correction – and the corresponding sustained period of relatively low inflation – is, of course, fully justified and most welcome. It also shows that adjustment mechanisms in the euro area work. A higher degree of wage flexibility would help to accelerate such desirable adjustment processes.

At the other extreme, some countries may, to some extent, be catching up with others' higher living standards. These countries are, therefore, possibly experiencing some temporary differences in competitiveness, reflecting movement towards a new equilibrium. Some other sources of persistent inflation differentials, however, might not be justifiable – for example, differentials attributable to insufficient flexibility. In some economies, weak labour productivity growth and strong increases in nominal wages and salaries over a sustained period inevitably result in a loss of competitiveness.

To sum up, diversity in terms of inflation and cost developments is undesirable when it reflects structural rigidities or a lack of competition. While we see evidence of a stronger common euro area cycle, we also see diversity in national trend growth. Monetary policy has a limited role in addressing such diversity. Changes in competitiveness are unfolding faster than was foreseen prior to the launch of the euro, which is good in some respect because it means that necessary adjustments in relative competitiveness can be more rapid. But it also suggests that a lucid monitoring of competitive indicators is of the essence to avoid possible rapid losses of relative competitiveness inside the euro area.

4. There is thus a clear need for sound economic management in EMU

The future of the euro area will rely as much on consolidating its achievement as in meeting some future challenges. I will argue now that the increasing interdependence among euro area economies, combined with the need to raise the level of economic performance while addressing excessive differentials in inflation, growth and competitiveness, requires sound economic management. Let me now stress the importance of four guiding principles in this respect.

a) The first principle is the **rigorous implementation of the Stability and Growth Pact** as a prerequisite for sound fiscal policies . There are several reasons for supporting sound fiscal policies. They are needed, for instance, to reduce the risk of fiscal policy spillover, both into monetary policy and, more generally, across countries. They are also needed to enhance flexibility and adaptability. Sound fiscal policies create the necessary conditions for flexibility, which cushions the effects of the economic cycle through the functioning of automatic stabilisers. Sound fiscal policies also ensure proper incentives. The tax and benefit system should avoid major distortions that affect incentives to work, save, invest and innovate, thereby making fiscal policy more efficient and growth-friendly. Moreover, the public sector also functions as a role model as regards, for example, wages or administrative prices.[10] Importantly, sound fiscal policies must also make provisions for the effects of population ageing.

b) The second principle for a sound economic management pertains to the **full completion of the Single Market**. This will enhance not only competition and efficiency, but also adjustment mechanisms in the event of adverse shocks. We still have significant progress to make in this domain, despite the fact that the Single Market was the goal of the founding fathers of the European Union, as set out in the Treaty of Rome, and despite the fact that this 50-year endeavour was very strongly reaffirmed with the Single European Act 20 years ago.

According to the OECD, product market regulation remains high in several euro area countries, and the level of such regulation in the euro area as a whole is considered significantly higher than in the United States. Let me also mention the fact that the services sector, which represents 70% of euro area GDP, is far from being fully integrated as an effective single market. We attach enormous importance to the full integration of financial markets, particularly because these play a decisive role in shock absorption and adjustment dynamics in a large single currency area. As far as cross-border labour mobility is concerned, empirical evidence suggests that it is still low in the euro area – both across countries and within countries – on account of several formal barriers across the euro area. This is in clear contrast to the situation in the United States, where labour mobility is considerable and greatly contributes to the adjustment process. Hence, more needs to be done to enhance labour mobility in Europe.

c) The third principle for a sound economic management is the **need to closely monitor the implementation of structural reforms**. Earlier I referred to some structural factors commonly contributing to inflation and growth differentials, as well as to disappointing growth in productivity. These detrimental factors include pervasive price and wage rigidities, excessive labour market regulation and the imperfect competition observed in several important sectors.

This has been recognised for quite some time. It is widely acknowledged that reforms are essential in order to raise factor productivity and potential output, to create new jobs, to achieve lower prices and higher real incomes, and to increase the resilience and flexibility of the economy. Yet, experience to date has clearly

[10] The behaviour of the public sector can, for instance, make social partners more aware of the trade-off between higher salaries and job creation. Furthermore, population ageing in most industrialised economies – and a significant increase in the old-age dependency ratio and higher healthcare and long-term care expenditures will exert growing pressure on public finances.

shown how difficult it is to undertake reforms in practice.[11] We have to persist and I shall flag some specific initiatives for reform in three main areas, namely:[12]

(1) **Getting more people into work:** Despite impressive achievements in job creation thus far, the still relatively high unemployment rates in the euro area (as well as the low participation rates in some countries) clearly suggest there is a need to stimulate not only labour supply but also labour demand. As regards labour demand, there is a need to reduce labour market rigidities as they restrict wage differentiation and flexibility, and thus tend to discourage the hiring of younger and older workers, in particular. Progress towards greater contractual flexibility must continue to improve in several euro area countries. Moreover, in those European countries where competitiveness has declined, or where the unemployment rate remains high, it is important that wage increases do not fully exhaust productivity gains. This in order to provide incentives for firms to create additional jobs.[13] Finally, as regards labour supply, further reforms in income tax and benefit systems would help to increase people's incentives to work.

(2) **Increasing competition:** Establishing efficient and well-functioning product and service markets can boost productivity trends by enhancing the incentive to invest and innovate, supports further employment creation, reduces inflation persistence and keeps upward price pressures contained, thereby improving the adjustment capacity of countries. "Little else than productivity growth matters in the long-run" – as Bob Solow[14] once put it. It is undeniable that, over the past two decades, significant progress has already been made in the context of the Single Market Programme. This has already yielded major benefits for European economies.[15] However, the extension and deepening of the Single Market still remains a high priority as regards further financial market integration, the pursuit of

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[11] The need for structural reforms was highlighted by the Lisbon agenda of 2000, which represents a fundamental and ambitious programme to draw Europe's attention to the major areas where changes are required. More recently, the Lisbon agenda has been refocused in the direction of growth and employment. Various attainable objectives have been set in order to enhance the flexibility and adaptability of labour markets, to raise competition in markets for goods and services, to increase employment, to promote innovation and to strengthen growth and employment rates in all participating countries.

[12] These topics are clearly reflected in the Integrated Guidelines for the new phase of the Lisbon Strategy and the recommendations for the euro area. We appreciate the renewed impetus toward reforms by some governments, which has now resulted in the more focused "Partnership for Growth and Jobs" and in the structural reform commitments of the national reform programmes. We also need to reinforce the benchmarking of good performance in order to identify with greater accuracy the areas where reform challenges are most urgent.

[13] In this context, the Governing Council considers that features that enforce wage rigidity and lead to non-optimal wage-setting, in particular, and the indexation of nominal wages to the consumer price index, should be avoided. This is especially relevant today, with the risk of second-round effects stemming from the impact of higher energy and food prices on wages. Avoiding these practices is essential to preserve price stability in the medium term and, in turn, the purchasing power of all euro area citizens.

[14] See the introductory article of the special issue on the slowdown in productivity growth in *The Journal of Economic Perspectives*, Vol. 2, No 4, 1988,.

[15] The European Commission recently estimated that the Single Market had created 2.75 million jobs and had brought about an increase in welfare of €518 per head in 2006, corresponding to a 2.15% increase in EU GDP over the period 1992-2006 (see European Commission, "The single market: review of achievements", November 2007).

effective competition in the energy market and the implementation of the Services Directive.[16]

(3) **Supporting an innovative environment:** The reforms that I have mentioned need to be accompanied by measures supporting innovation through higher investment in research and development and policies geared towards improving human capital. Europe needs many new and dynamic firms that are willing to reap the benefits of opening markets and to pursue creative or innovative ventures. Notably, it is new and smaller firms – rather than large ones – that are the job creators. This requires an entrepreneur-friendly environment with less "red tape", and easier access to the finance these firms need. Europe is lagging significantly behind in this field; its venture capital financing, for instance, remains only a fraction of that in the United States, relative to the size of its economy.

We know that research and development, as well as human capital, make valuable contributions to TFP growth. In 2006, R&D investment relative to GDP was only 1.9% in the euro area, compared with 2.7% in the United States.[17] Cooperation between universities, public sector research institutes and industry must also intensify to raise the efficiency of public R&D spending. Unfortunately, in several euro area countries, investment in human capital is still too low for a "knowledge-intensive" economy. Instead, the employability and flexibility of the labour force requires human capital to be continuously adjusted to labour market needs. This investment should start "early" by enhancing the quality and efficiency of our schools and universities, and be continued through lifelong training and learning.

d) The fourth principle for a sound economic management is the **need to monitor unit labour costs and national competitiveness indicators** so as to prevent or correct abnormal deviations. We would expect some dispersion and differentials among euro area countries. As I have already mentioned, in such a vast area, there will always be some diversity, as in the United States. Countries catching up in terms of GDP per capita and price levels are always likely to have stronger output growth and higher inflation. Diversity may also extend to correcting past excesses in terms of overall cost and price competitiveness, particularly in the markets for tradable goods and services. In such situations, national governments and social partners need to take action to address excessive wage developments and to strengthen productivity growth, so that unit labour costs in those economies increase less rapidly than the euro area average.

To sum up, this sound economic management can foster economic stability and growth, as well as reduce the impact of adverse shocks, or facilitate the adjustment thereafter. The attentive monitoring of economic and financial developments, and of changes in competitiveness in particular,

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[16] Understandably, for the ECB, further European financial integration is essential given its relevance to the conduct of the single monetary policy. Considerable progress has already been made across various market segments. Financial integration is generally more advanced in those market segments that are closer to the single monetary policy. While the euro area banking markets for wholesale and capital market-related activities have shown clear signs of increasing integration since the introduction of the euro, the retail banking segment has remained more fragmented, leaving European firms and consumers unable to take full advantage of EMU and the Single Market.

[17] While many Member States expect to increase their spending in this area, the EU will fall short of its overall target of 3% of GDP by 2010. Increasing investment in research and development is not, of course, an objective in itself. If we want to see an impact on growth, it is also the return on that R&D that matters.

must be an integral part of this economic management. The public's understanding and acceptance of these elements is also crucial. That is why we always strive to explain what actions we are undertaking, and why.

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Ladies and gentlemen, let me now conclude.

The past ten momentous years have been rich in achievements. The introduction of the euro has been recognised as a remarkable success. Since 1999, the single currency has fully inherited the degree of credibility and confidence that was the privilege of the most credible national currencies prior to the euro. Inflation expectations are well anchored, and medium and long-term interest rates in the euro area are at the same low level as the levels observed for the most credible of these former national currencies. We also see a remarkable degree of resilience in a complex international environment.

These achievements are a solid foundation for our future. But we also know that the challenges lying ahead for the euro area are still demanding. What do we need to do, over the next ten years and beyond, to consolidate the remarkable success of the euro and improve the performance of euro area economies? We, at the ECB and the Eurosystem, must preserve the quality of our monetary policy. This will safeguard all the benefits expected of price stability in terms of low current and expected inflation and interest rates.

To strengthen the "E" in EMU, we need to focus on a sound economic management and we need to secure a broad base of acceptance for it. This entails: a rigorous implementation of the Stability and Growth Pact; the completion of the Single Market; the implementation of the structural reforms envisaged in the Lisbon agenda; and a careful monitoring of national unit labour costs and competitiveness indicators.

The achievements that I have described and the visible benefits of the euro support this sound economic management. These achievements and benefits help national governments to adapt and further liberalise their economies.

Thank you for your attention.

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