Erkki Liikanen: The tenth anniversary of the euro – a time to reflect

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Professor Ragnar Nurkse seminars, Bank of Estonia, Tallin, 10 September 2008.

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It was only ten years ago, in May 1998, when European leaders decided to launch the third stage of Economic and Monetary Union.

The *European Central Bank* was founded a month later, in June 1988. Under the Maastricht Treaty, the new monetary institution was granted full independence to conduct monetary policy, with price stability as its primary objective. The task of defining price stability was given to the Governing Council of the ECB, in which the Governor of the Bank of Finland was, and is, a member.

At the same time, an informal discussion forum, the *Euro Group*, was created by the Ministers of Finance and Economic Affairs in the euro area countries to discuss issues related to EMU, such as the economic situation, coordination of economic policies, structural reforms, enlargement of the euro area and the external representation of EMU.

Introduction of the common currency and common monetary policy had been preceded by four years of very intensive legal, regulatory and logistical preparations. It was necessary that the infrastructure for the common monetary policy was fully operational from the first day. These preparations had remained largely unnoticed by the public at large.

The creation of Economic and Monetary Union was also preceded by a great number of sceptical remarks from many commentators, including academic economists. Many experts in international macroeconomics doubted that a single monetary policy could suit countries whose economies diverged in many respects.

The second major milestone, and the biggest one for euro area citizens, was January 2002, when the changeover from national notes and coins to euro notes and coins took place in 12 EU member states.

The euro area has since expanded by a further three countries, and, at the beginning of next year, the area will welcome another new member.

Three months ago, in June, we had the tenth anniversary of the European Central Bank. The coming New Year will mark the tenth anniversary of the common currency, the euro. Today everybody, including the vocal critics, agree that EMU and the euro have been a great success.

But there is no doubt that many important challenges still remain. In the rest of my talk, I will reflect on the successes and challenges of EMU from both a European and a Finnish perspective.

European perspective

Monetary stability

Monetary stability is the greatest achievement of EMU. By monetary stability, I mean the absence of tensions on the money and currency markets. These tensions diminished and practically disappeared on the road to EMU. The launch of EMU then made such tensions impossible between the participating countries.

But EMU has also contributed to monetary stability in non-participating countries. Many of these countries have the objective to join EMU and are therefore committed to conducting stability-oriented policies to make participation possible at a later date.

EMU has contributed to the monetary stability of floating exchange countries as well. This is because these countries have also conducted stability-oriented policies aiming at low inflation and sound government finances.

Two forces have contributed to this effect. *Firstly*, there is a size effect. Smaller neighbours have an incentive to conduct stability-oriented policies as long as they have a large neighbour with predictable monetary policy aiming at low and stable inflation. Deviation from such a policy would hurt the smaller neighbours, not the large currency area. The cost would be higher risk premia and higher real interest rates. We only have to recall that in the 1970s and 1980s Germany had lower real interest rates than its neighbours, which were less successful in maintaining monetary stability.

Secondly, there is a political-economy argument. The existence of a large area of monetary stability makes it easier, or at least less difficult, for the political leaders of smaller neighbours to resist in situations where special interest groups are calling for more inflationary policies. They might sometimes think that they suffer from too high interest rates or too strong an exchange rate. The risk of time inconsistency is thereby reduced.

European history has witnessed repeated episodes of monetary instability. Typically, the instability has been caused by an economic slowdown or recession. This was the case at the beginning of the 1980s and the 1990s, as well as in the mid-1970s. The ultimate trigger for instability was the different policy reactions to the shocks that occurred at these times.

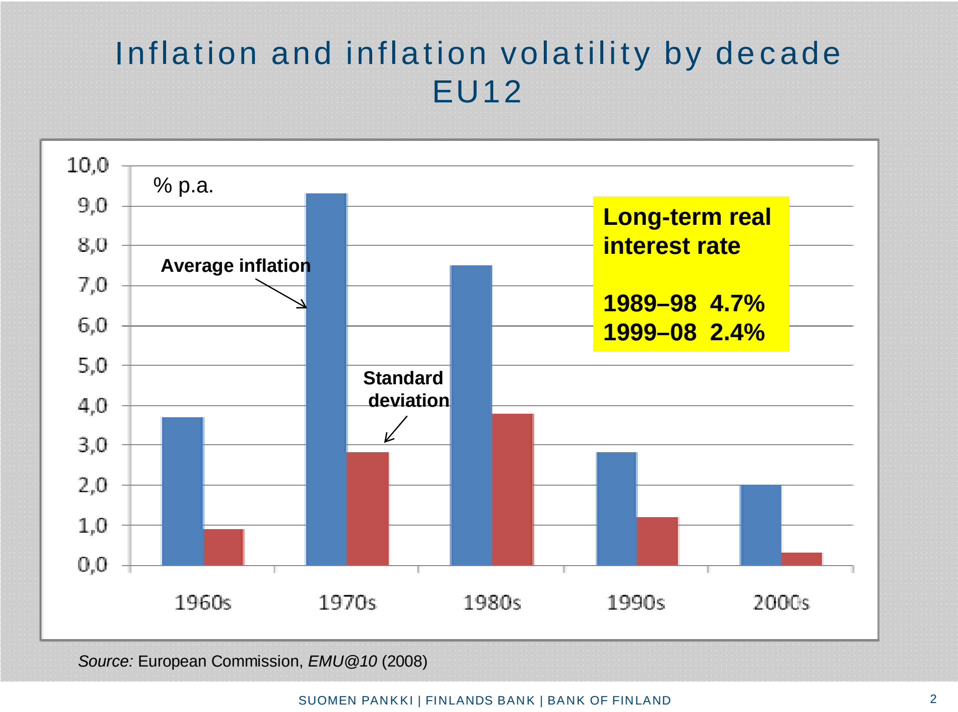
Europe is now going through a challenging period. Economic activity is weakening due to higher commodity prices, which dampen consumption and investment, and also due to the uncertainty the recent financial market turbulence is causing for the growth outlook. Had EMU not been a reality, we would probably now be experiencing a similar, or even worse, monetary mess than Europe experienced at the beginning of the 1990s.

Price stability

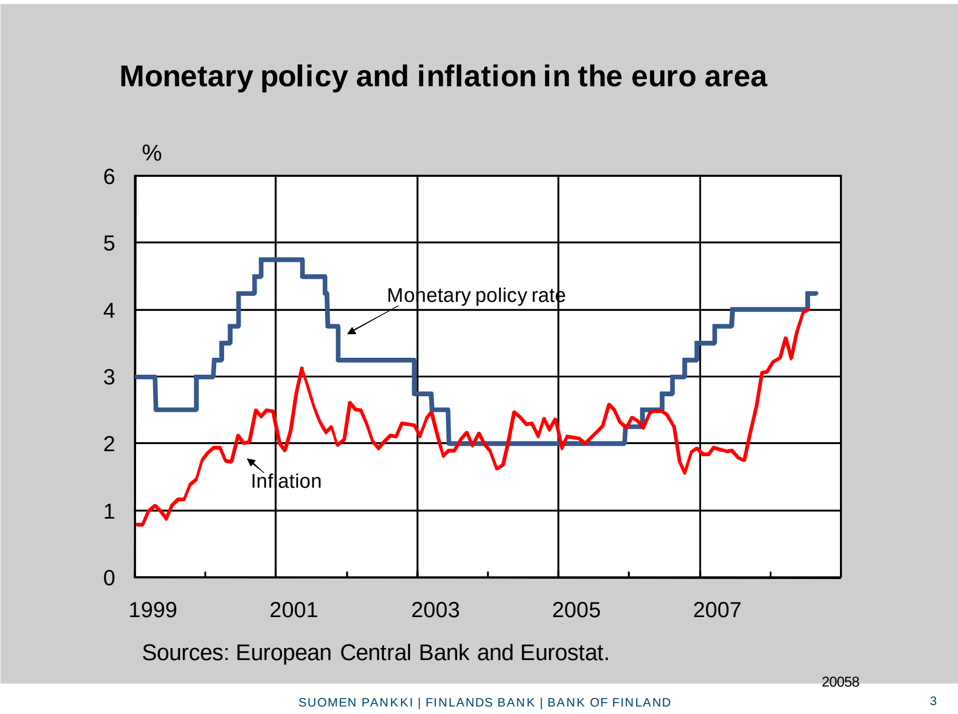
Monetary stability and price stability are inseparable. We cannot have monetary stability without price stability. Price stability, in turn, is a precondition for sustainable growth. It reduces uncertainty, which is reflected in lower real interest rates, thus supporting investment. It also promotes competition, which accelerates productivity growth. Productivity growth, in turn, has always been, and will continue to be, the primary source of increasing prosperity.

Average Inflation in the euro area in the period 1999 to 2007 has been *slightly above* 2%. This is low compared with 4% in the early 1990s and 8% in the 1980s, not to mention the double digit inflation of the 1970s.

It is not true that lower inflation would imply higher real interest rates, as some people today still seem to think. On the contrary, inflation risk premia diminish as inflation uncertainty diminishes, and nominal interest rates decline as low inflation becomes firmly anchored in expectations. This is illustrated by the fact that the real long-term interest rate in the euro area countries (EMU12) has been 2.4% since 1999, compared with 4.7% in the period 1989 to 1998.



The ECB's definition of price stability is the rate of increase in the Harmonised Index of Consumer Prices being *close to but below 2%* in the medium term. Against this benchmark, the inflation performance of the euro area has not been entirely satisfactory. But the deviation is understandable, given the repeated upward shocks in the relative price of oil.



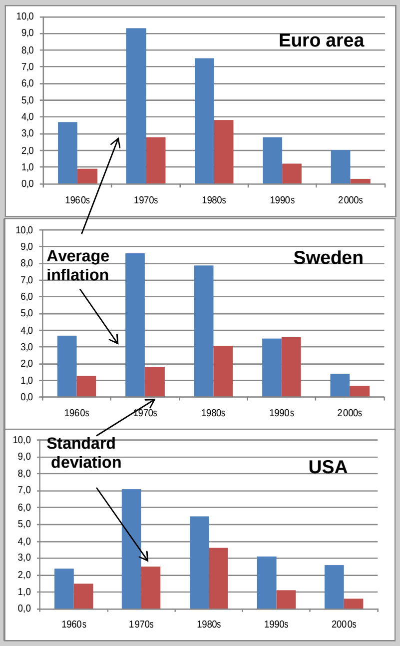
The recent resurgence of inflation, however, is a far more serious concern than the small deviation of the inflation outcome from the price stability objective. The latest figures on euro area inflation now stand at a level which is almost twice as high as the ECB's definition of price stability.

Admittedly, much of this acceleration in inflation is, once again, attributable to relative price shocks, that is, to increased commodity prices. The central bank cannot (and should not attempt to) affect relative prices. There is a risk, however, that relative price shocks of this kind can raise longer-term inflation expectations and affect price and wage-setting behaviour, creating a price-wage cycle and finally disanchoring inflation expectations.

The euro area is not the only region which has been able to enjoy low inflation for an extended period of time. Most OECD countries had similar experience of disinflation in the 1980s, and they achieved a similar degree of price stability as the euro area by the end of the 1990s. Average inflation in Sweden, for example, has since 1999 been half a percentage point lower, and in the US half a percentage point higher, than in the euro area on average.

Low inflation – a global achievement

- Low inflation and low inflation volatility achieved in most developed countries
- Institutions matter:
  - central bank independence
  - well-defined target for monetary policy
  - transparency and accountability
- Monetary stability in the euro area has made it easier for neighbours to maintain stability



Source: European Commission, *EMU@10* (2008)

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The role of institutions

Why this similarity?

Globalisation has no doubt increased competition and lowered the prices of manufactured goods worldwide. Globalisation and the enlargement of the EU have contributed to wage moderation, because of the threat of competition coming from low-wage countries.

Globalisation in itself, however, cannot be the cause of low inflation. But it has made it easier for central banks to maintain low inflation at comparatively low interest rates. This, in turn, may have contributed to (sometimes excessive) asset price inflation in different parts of the world.

A more fundamental factor contributing to low inflation worldwide was the institutional reform that profoundly changed the role of the central bank in most countries. The innovations of the early 1990s were central bank independence, price stability (or low inflation) as the primary objective of the central bank, and an emphasis on the accountability of central banks.

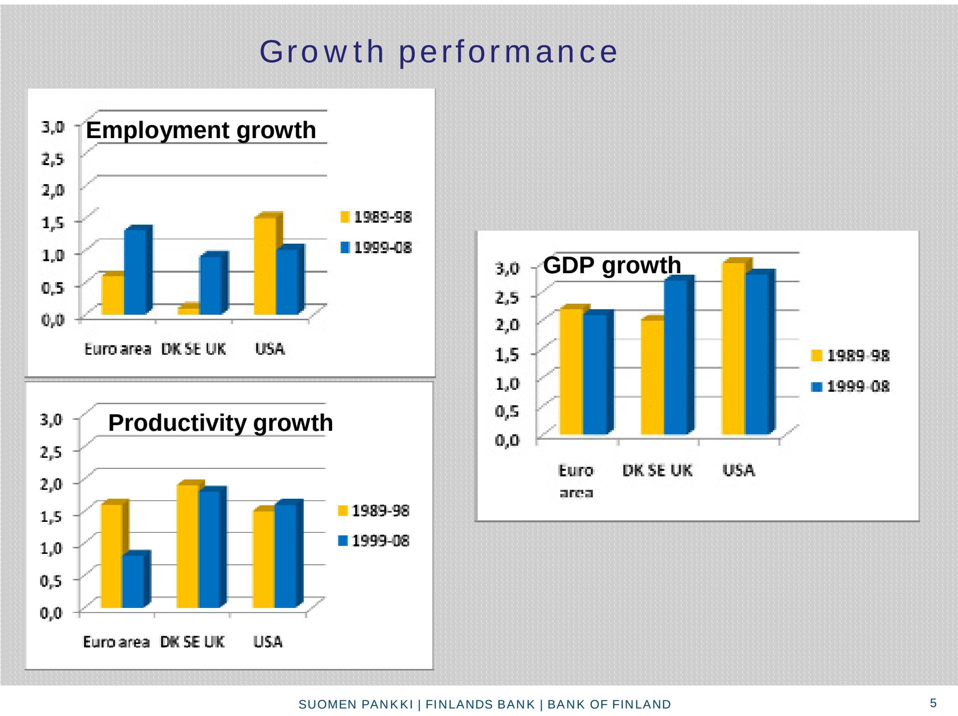
These cornerstones were written into the blueprint for EMU, the report of the Delors Committee. The Maastricht Treaty made the institutional reform obligatory for all EU central banks. Many other countries outside the EU, and outside the European continent, have implemented similar institutional reforms. This proves that such a reform has been judged to serve the national interest in a wide variety of countries. The central banks of those countries have in most cases been successful in meeting their inflation targets, which has contributed to monetary stability worldwide.

Central bank independence and accountability alone are not a sufficient guarantee of the happy coexistence of price stability and sustainable growth. In addition, we need fiscal restraint to prevent a widening of public deficits so that they put upward pressure on real long-term interest rates and crowd out private spending. In the worst case, they could ultimately lead to the removal of central bank independence, with central banks being forced to rescue governments. That would signal the end of monetary and price stability.

Economic performance

While inflation performance since the start of EMU has been satisfactory – excluding recent months – we have no reason to be happy with growth performance.

Economic growth in the euro area since the launch of the euro has averaged 2.1%, compared with 2.6% growth in the United States and 2.7% on average in the three non-participating member states: Denmark, Sweden and the UK. Labour productivity growth has been very modest, at 0.8%, which is only half the average productivity growth in the above-mentioned benchmark countries.



But we must admit that employment growth in the euro area has been impressive. Since the launch of the euro, 16 million new jobs have been created in the area, compared with 13 million new jobs in the United States in the same period. Unemployment has come down from a peak of 11% in the mid-1990s to 7% today.

This strong labour market performance tells us that labour market reforms – where such reforms have been introduced – have brought about the desired results. These reforms have contributed to a rise in employment among less-skilled workers, which partly explains the slow rate of labour productivity growth.

Despite the improvement, the situation on the labour market is far from satisfactory. Employment rates are low compared with the US or, for example, the Nordic countries.

These observations could, however, be turned into a more positive story. A low employment ratio tells us there is a lot of potential for growth in the labour force. International comparisons have shown that the euro area lags behind the US in the use of ICT in services. More investment in ICT, and especially in reorganisation of the work which ICT enables, would help to close the productivity gap and would raise per capita GDP closer to the US level.

This can be seen as a promise for the future: There is plenty of room for improvement with better use of existing resources and better utilization of existing technologies. On top of this, there is plenty of room for innovation and upgrading our human capital.

Employment rates would increase and the productivity gap would close, albeit gradually, if there were proper incentives in place. These incentives can be created by implementing structural reforms in product and labour markets.

Structural reforms typically increase competition in both these markets. Competition increases entry and exit of firms, a phenomenon which is sometimes called “creative destruction”. This requires greater adaptability and mobility than many people are willing to accept, which explains why it is so often politically difficult to introduce structural reforms. To reduce the resistance to change, social safety nets and positive adjustment support may be necessary.

Model calculations show that increased competition may bring about significant positive effects. A study by Bayomi, Laxton and Pesenti from 2004 suggests that increasing competition in the euro area to the US level could boost output by no less than 12%.

A Bank of Finland study from 2006 examined the effects on the Finnish economy of a general increase in competition both in product markets and in labour markets. The increase in competition is defined as a reduction of excess rents in these markets by just a fifth – in other words, monopoly profits in the economy are reduced by 20%.

This assumed reduction in rents is rather modest, and the model does not assume the increased competition to have any effects on the rate of technological change, so the total impact on output is not huge, at only about 3%. But more interestingly, real wages, which initially fall, as wages are brought closer to the labour market equilibrium, soon rise again, and end up also 3% above their initial level. Moreover, employment increases by almost 2%.

Much of the early debate on structural reforms in Europe focused on the labour market. The product market has been in the focus more recently. There are obvious interconnections between the two markets. If the product market is characterised by full competition, there are no rents (extra profits) on the distribution of which the workers could negotiate. There is simply no room for any wage mark-ups.

Frictions in the capital market are a less debated area. Yet they play an important role not only in financing the investments of existing firms, but also in the reallocation of capital from less productive to more productive uses. This is a part of the “creative destruction” by which the economy adapts to changes in the environment and raises its total factor productivity.

There has been a lot of debate and analysis of financial integration. We know the euro has catalysed substantial integration in markets closely linked to monetary policy. In particular, the interbank markets are well integrated – or at least they were, and hopefully will be again, once the turmoil passes – as are the government bond markets and, increasingly, also the corporate bond markets.

However, much still remains to be done in other areas. The infrastructure supporting the bond and equity markets is fragmented and hinders competition. Retail banking continues to be mainly national, except in our two countries and some others.

We know from experience that protected sectors seldom develop, because they lack incentives. And so it is also in financial services: it is the pressure of cross-border competition that will motivate innovation and productivity improvement within the financial sector. The best way to guarantee a high level of financial services for EU citizens is to remove the remaining obstacles to competition.

Financial development goes hand in hand with financial integration. Financial development is, in turn, an important determinant of competition, innovation and, thereby, productivity in the whole economy.

Without well-functioning financial markets, economic power would be in the hands of those who have liquid wealth, collateral and connections, not in the hands of those who have ideas. That would be a recipe for stagnation.

Financial markets create the opportunities for newcomers to dislodge the incumbent, to leapfrog them by innovating. Competition increases, monopoly rents fall and productivity rises.

The Finnish perspective

Finland's road to EMU

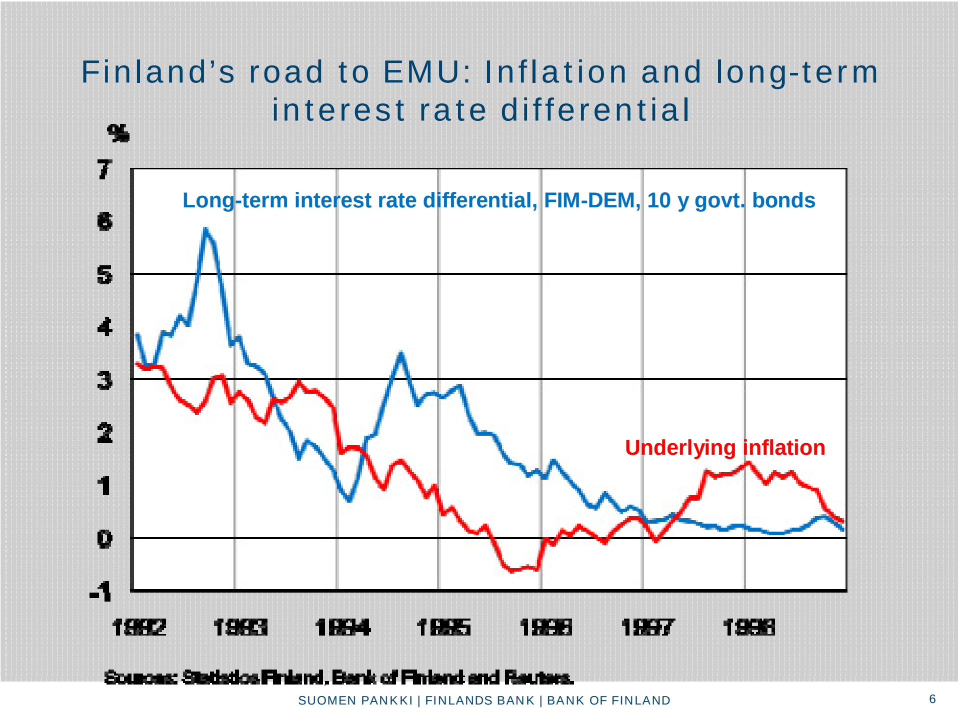
Finland was among the first group of countries that moved to the third stage of EMU at the beginning of 1999. Finland had been a member of the EU for three and a half years at that time. The currency had been part of ERM2 for less than two years.

At the time of Finland's accession to the European Union in 1995 it was not yet certain that EMU would become a reality. The likelihood that Finland would be in the first group of countries was even lower, as could be read from poll results and from the financial market data.

Like most other countries, Finland did not meet the EMU entry criteria in 1995. The general government deficit was not projected to reach 3% any time soon. At that time, the Finnish markka was not participating in the ERM.

The floating exchange rate (since September 1992) and inflation targeting (since February 1993) had served the country well. In the course of 1994, short-term interest rates came down rapidly, the currency appreciated, and the foreign exchange reserves of the Bank of Finland were restored.

The inflation target of 2%, which was to be achieved by1995, was met one year in advance. The financial market's confidence in the Finnish economy started to return in spring 1995, and this was reflected in a sharp drop in the long-term interest rate differential vis-à-vis Germany.



The decision to participate in the ERM was taken in October 1996. In January 1997, there was short-lived speculation about a revaluation of the markka, and the Bank of Finland had to intervene heavily. Otherwise, the currency markets remained tranquil. The government finances improved more rapidly than anticipated, with the deficit having disappeared entirely by 1998.

Effects of EMU on the Finnish economy

A frequently asked question is: How much has Finland's participation in EMU affected the performance of the Finnish economy?

There is no obvious answer to this question. Furthermore, any answer would be impossible to verify empirically, simply because we cannot repeat history with Finland remaining outside monetary union.

There are, however, at least two ways to approach this question. One is to compare actual experience since 1999 with the expectations that prevailed before monetary union became a reality. The second is to compare Finland's experience with that of a comparable country which decided not to participate.

Expectations and outcome

One area where the expectations have been fulfilled, or even exceeded, is monetary and price stability. For Finland's citizens this has meant historically low and stable interest rates and low (or no) inflation for most of the time.

Since 2002 until very recently consumer price inflation in Finland was the lowest or one of the lowest in the whole euro area. With short-term interest rates being equal across the euro area, this implied higher real short-term interest rates in Finland than in the rest of the euro area. Apparently this did in no way affect consumer sentiment in a negative direction. Rather, on the contrary, consumers' confidence in their own economic situation has remained high throughout the period.

In the late 1990s, there was a lot of debate about the possibility of asymmetric shocks. In Sweden they had a similar debate. The fears of **adverse** asymmetric shocks never materialised.

It is ironic that the first asymmetric shock turned out to be a positive one. The worldwide ICT boom in 1999-2000 had a disproportionately large impact on Finland given the importance the sector had gained in the 1990s.

This favourable asymmetric shock would have been expected to cause a real appreciation of the currency. Outside EMU and under floating exchange rates and inflation targeting, the currency would most likely have appreciated in nominal terms, hurting non-ICT industries. Employment development would have been weakened.

With a less than fully credible fixed exchange rate (as in the 1980s) the likely outcome would have been higher inflation and increased exchange rate uncertainty and higher interest rates later on.

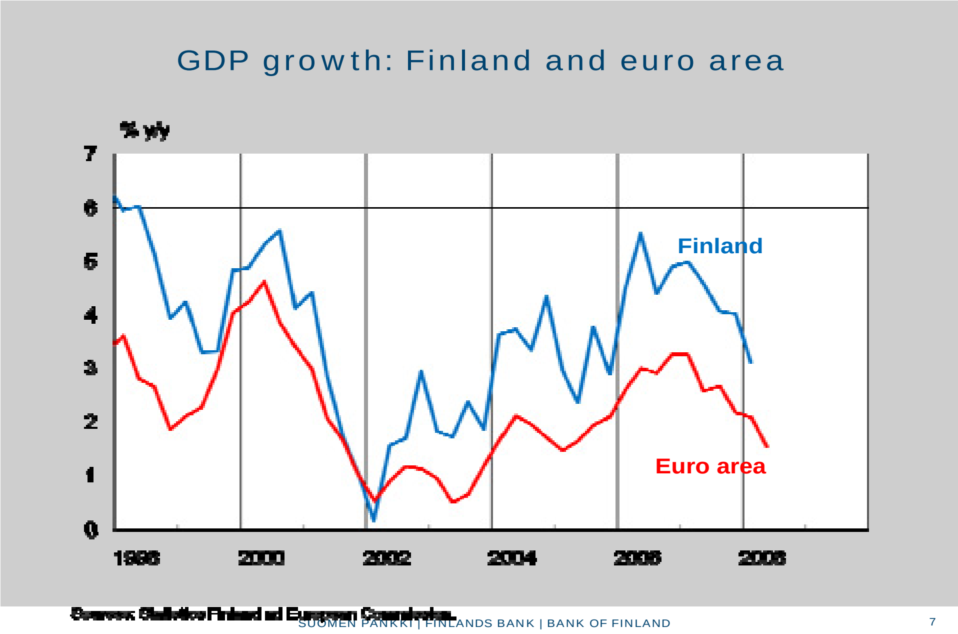
In reality, inflation did accelerate somewhat in 1999–2000, but inflation expectations remained constant. Participation in EMU had a stabilising effect in the face of a positive asymmetric shock.

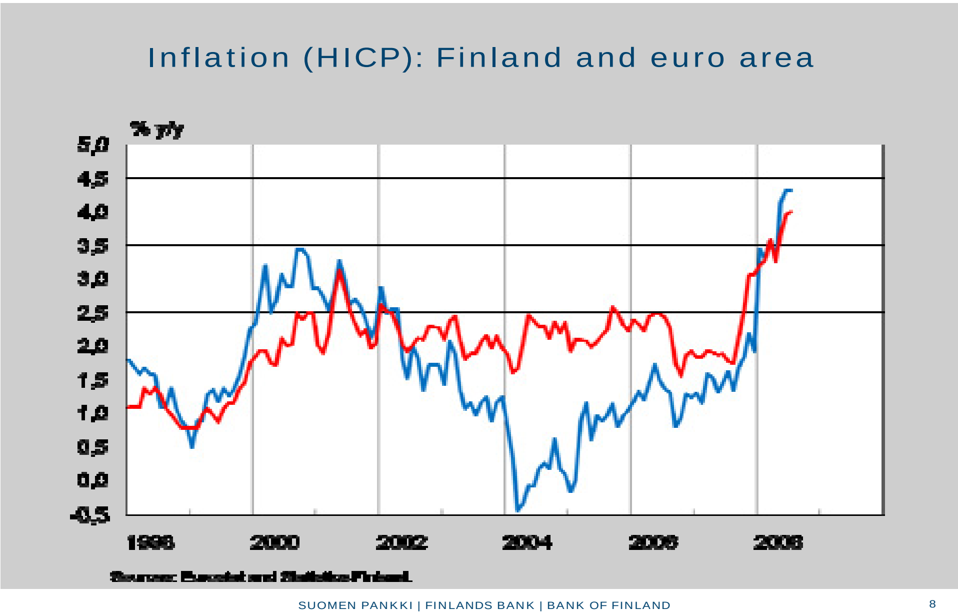
The expectation in the mid-1990s was that accession to the EU and eventual participation in EMU would enhance competition, with a favourable impact on productivity growth. There is no doubt that competition has increased in many areas. EU membership was particularly important because it opened the borders for imported food to flow in, as a result of which retail food prices declined by about 10% in 1995-6.

In other areas, the effects of EU membership or EMU participation are difficult to separate from other influences, such as the "creative destruction" process sparked by the deep recession and the rapid rise of the ICT sector. There is anecdotal evidence that EMU had an anticipatory effect on productivity: once the option to devalue is taken away permanently, it is better to adjust early and pay attention to productivity.

Comparison: Finland and Sweden

The macroeconomic performance of Finland has been rather favourable since 1999: that is, the period of Finnish participation in monetary union. Annual economic growth has been [above 3%] on average, which is high by European standards. Consumer price inflation has been below 2% on average, one of the lowest in Europe. Employment has been growing and the unemployment rate has declined steadily during all these years. Government finances have shown surpluses in each year, and the general government debt ratio has declined rapidly and is currently one of the lowest in the euro area.





A frequently asked question is: How much did Finland's participation in EMU contribute to this favourable development?

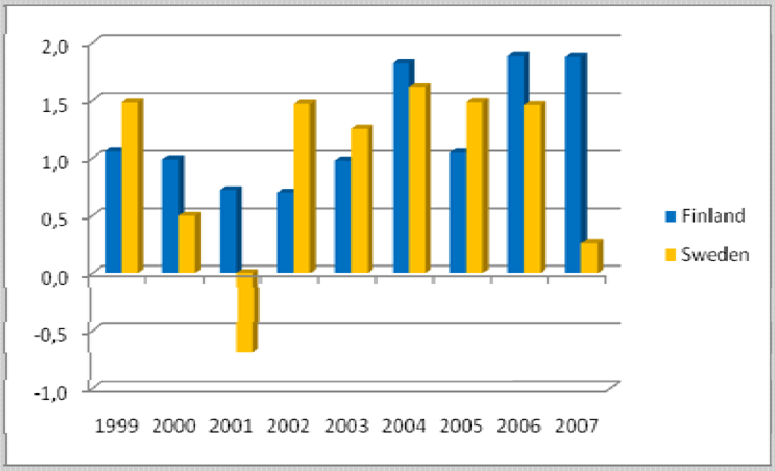
Again there is no simple answer to this question. Membership of EMU by itself cannot explain the above-average economic growth. Above-average performance must be attributable to something that is country-specific.

Participation in EMU has no doubt contributed a lot to the favourable macroeconomic performance by boosting competition and productivity and lowering transaction costs. But that is not a sufficient explanation on its own. The causes must be found elsewhere. A comparison with a structurally similar country outside EMU might help to identify these essential conditions. Sweden is an obvious candidate for such a comparison.

Sweden joined the EU at the same time as Finland, but decided not to link its currency to the ERM and thus did not fulfil one of the entry criteria for EMU. Sweden has conducted an independent monetary policy based on a floating exchange rate and a numerical inflation target of 2%, with a tolerance range of +/- 1%.

The macroeconomic performance of Sweden has been very similar to that of Finland over the past ten years. Economic growth has been about the same as in Finland and clearly above the euro area average. Inflation has been below 2% most of the time. Employment has developed favourably. Open unemployment has been somewhat lower than in Finland. Government finances have shown surpluses [in each year]. The general government debt ratio is, along with Finland, one of the lowest in the euro area.

GDP growth differentials vis-à-vis the euro area



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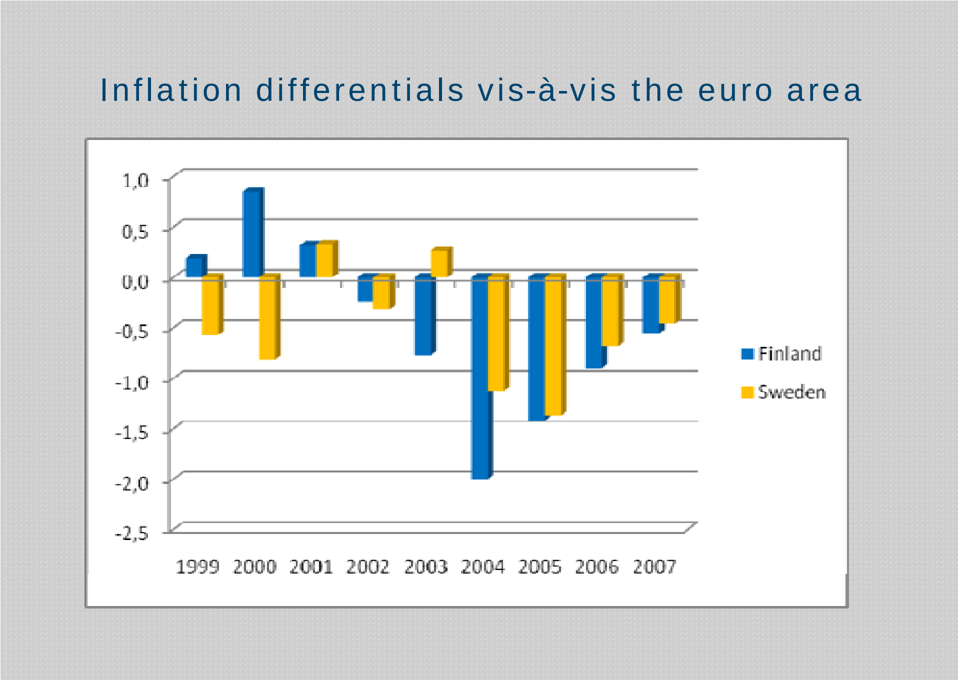

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Thus, a quick comparison of macroeconomic performance does not provide an answer to the question of whether participation in EMU has been beneficial for Finland.

The fact that Finland's macroeconomic performance has been favourable proves only *that participation in EMU has not been harmful to Finland*. It does not prove that participation has contributed to this favourable performance.

The fact that Sweden's macroeconomic performance has been favourable proves *only that Sweden has not suffered from non-participation in EMU*. But it does not prove that the non-participation has contributed to this favourable performance.

The popularity of monetary union was not particularly high in Finland on the eve of EMU. According to a Eurobarometer survey conducted in autumn 1997, only one third of Finnish citizens supported the idea that EMU with one single currency would be “a good thing”. Finland was clearly an EMU-sceptic country at that time, together with the UK, Denmark and Sweden.

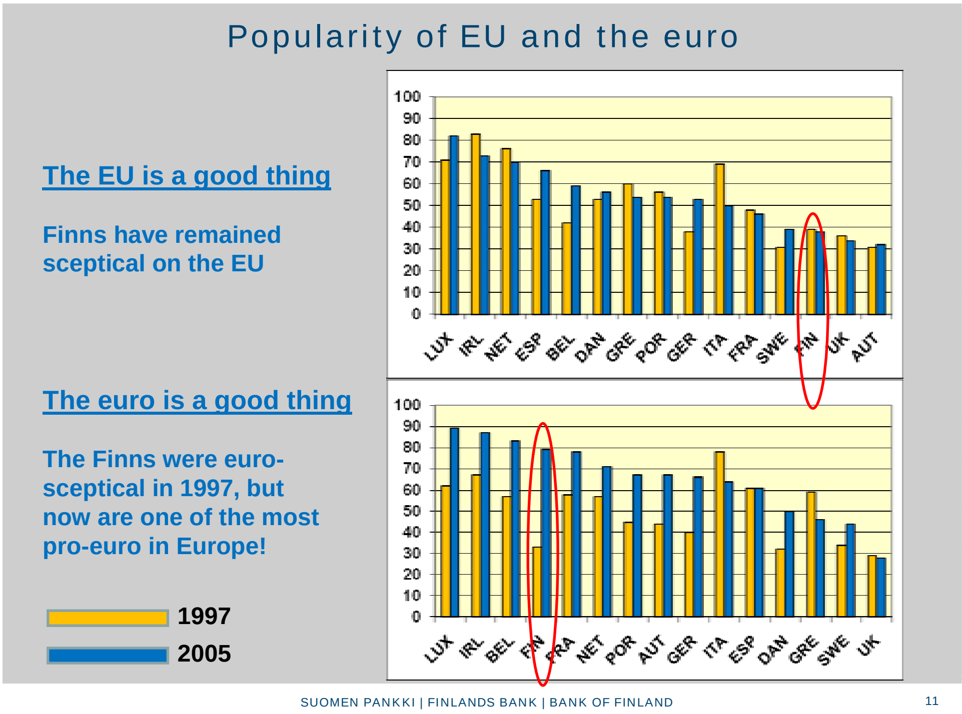
Moreover, the support of Finnish citizens for membership of the EU was surprisingly low in 1997. Less than 40% regarded membership as “a good thing”. The Swedes were equally sceptical, while the Danes were much more favourable, with 55% of citizens regarding membership of the EU as “a good thing”.

By 2005, Finns’ support for the EU was still low, but support for EMU had surged and was the fourth highest in the EU with a score of 80%. Swedish perceptions had changed much less, but still favourably.

The final question then is: What explains the favourable macroeconomic performance of Finland and Sweden?

The answer might be: Both countries have sound public finances. Inflation expectations have been well anchored in both countries (at least until recently). Both have comparatively flexible product and labour markets. Both countries are open economies and they are in favour of free trade.

To put this briefly: both countries have had modern economic policies.



Conclusions: Nurkse would not disagree

Ragnar Nurkse had great experience of a broad range of economic issues such as monetary instability and financial disorder as well as trade wars and competitive devaluations – and, finally, of macroeconomic and political instability culminating in military conflicts and ultimately war.

Nurkse was more than an observer; he was a top-ranking scholar in international monetary economics. He was also a policy adviser with an ambition to design rules to improve international coordination as well as better coordination of domestic economic policies. He prepared a study for the League of Nations entitled *International Currency Experience* (1944). This report was distributed to delegates at the United Nations Monetary and Financial Conference at Bretton Woods in July 1944. His study contained many of the seeds of the Bretton Woods Agreement, although he was not among its architects.

Ragnar Nurkse was in favour of fixed but adjustable exchange rates. He understood that a precondition for such an arrangement is an agreement with the major powers on the coordination of economic policies. For it to function smoothly, the major powers would have to pursue disciplined monetary and fiscal policies with the objective of price stability. Interestingly, price stability was not among the objectives of the Bretton Woods Agreement.

Many modern elements were present in the thinking of the economists at the League of Nations. Nurkse was one of those modernists. Endres and Fleming (1998) mention that Nurkse's colleagues at the League of Nations had recommended rules-based monetary policy and central bank independence already before him (Nurkse joined the League in 1934).

Disciplined monetary and fiscal policies in major countries continue to be a prerequisite for international monetary stability. Nurkse would not disagree.

Central bank independence, a monetary policy strategy based on the objective of price stability, central bank transparency which makes monetary policy predictable, and the elimination of excessive deficits are the cornerstones of macroeconomic policies in Europe today. Nurkse would not disagree.