

## **Jean-Claude Trichet: Ten years of the euro – successes and challenges**

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, Osnabrück, 12 February 2009.

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### **Introduction**

Dear President Pöttering, Dear Dr. Hentschel, Ladies and gentlemen,

I thank you for inviting me to Osnabrück. Today I'm going to speak to you in German. That is for me both a pleasure and a challenge. I'm pleased to have come here, for the Osnabrück region is the home of Hans-Gert Pöttering. I have got to know, and have come to hold in high esteem, Hans-Gert Pöttering as President of the European Parliament. As the President of the European Central Bank, I am a regular guest at the Parliament. For us at the ECB, relations with the directly elected representatives of the people of Europe are very important.

Osnabrück is also a suitable place for a speech on European integration. Its epithet is the "city of peace". It was here and in Münster that the Peace of Westphalia was negotiated. It was the basis for peace in Europe in 1648 after the Thirty Years' War. Today it is European integration that forms the basis for prosperity and peace in Europe during the last 60 years.

### **Main part**

The euro is the most visible symbol of European unification. Economic and Monetary Union is the field in which integration has progressed the most. The euro is the currency now shared by 329 million people in 16 countries. Ten years ago – on 1 January 1999 – it was introduced in the then 11 countries of the euro area. Ten years is a short time in history. But it represents a good opportunity to talk about successes and challenges – the subject of my address tonight.

I wish to consider this theme by asking three questions:

1. How successful is the euro?
2. What is the euro's role in the current financial market turbulence?
3. What challenges lie ahead for the single currency?

I intend to refer to a series of current issues relating to the global financial market turbulence and economic developments in the euro area.

The first question:

#### **How successful is the euro?**

The euro is a stable currency and is an important contribution to the completion of the Europe's single market. That's why it is a success. After all, it helps to secure prosperity in the participating states.

#### ***Stability of the euro***

Let me first of all consider the theme of stability. Before the euro was set up there were reservations about the stability of the future single currency, including in Germany. The first ten years have shown that these fears were unfounded. The euro is just as stable as its most stable predecessors, which were merged into it. That applies of course also to the Deutsche Mark. "The euro will be as strong as the Mark", it was said. That promise has been kept.

A glance at the inflation rates in the euro's first decade makes this clear: the average annual inflation rate in the euro area in the ten years since the introduction of the currency was 2.2%. By comparison, the average annual rate of inflation in Germany in the 1990s, before the euro was introduced, was also 2.2%. In the 1980s, the rate was 2.9%, in the 1970s 4.9%. In other words, in terms of stability, the euro does not need to shy away from any comparison with the Deutsche Mark and other legacy currencies.

At 2.2% per year since 1999 average inflation was somewhat above the level that the ECB's Governing Council has defined as price stability: an inflation rate of below, but close to, 2% in the euro area, over the medium term. Nevertheless, the result remains good, for the first ten years were anything but calm. In particular, we had an oil price shock, which was certainly comparable with that of the 1970s. Between early 2002 and mid-2008, crude oil prices in dollar terms rose by nearly 600%. In the case of food prices as well, we faced price pressures: at the beginning of the decade, and in particular in 2007 and 2008 by the global rise in food prices.

Despite these shocks and short-lived erratic price movements, inflation rates remained generally low. Above all, inflation expectations were and are firmly anchored at a level in line with our definition of price stability. In other words, economic agents and financial market participants expect the ECB to ensure price stability over the medium and long term whatever the amplitude of the short-term impact of the various shocks it has to cope with. They trust our commitment to stability. This is expressed most clearly by the issue of euro-denominated bonds with a maturity of 30 and even 50 years, the yields of which stand at a remarkably moderate level. For example, a 50-year French government bond maturing in 2055 currently yields 4.1%. This implies confidence into the stability of the euro – in its function as a store of value – extending beyond more than one generation.

### ***Cash changeover and price increases***

I know that in Germany and in other countries in the euro area the introduction of euro cash in 2002 was “associated” with price increases. Was the euro “a Teuro”? There were some price increases in the course of the cash conversion. The statistics office of the European Union – Eurostat – estimates that the cash conversion added between 0.12% and 0.29% to the inflation rate in the euro area in 2002. This was overall small in 2002 and negligible over the ten years of the euro. Also to be noted is the discrepancy between the “felt” inflation and the actual, statistically measured inflation. This discrepancy cannot be attributed to a measuring error in the consumer price statistics. These statistics are of high quality.

There are some reasons for the deviation between “felt” and measured inflation after the cash conversion. For example, price increases occurred particularly in the case of frequently bought goods and services usually paid for in cash. Such prices are more strongly “felt” than prices for products which are only bought from time to time, for example, cars or computers. It is also possible that consumers are still comparing current euro prices with prices in the national currencies before 2002. This “frozen price memory” leads to distorted comparisons.

It also needs to be taken into account that the introduction of euro cash in January 2002 coincided with increases – caused by external factors – in energy and food prices and in indirect taxes. They were not at all related to the euro. In the public perception, however, they were associated with the cash changeover.

### ***Institutional foundations of the euro***

Many observers did not think the ECB could ensure price stability and anchor inflation expectations. Indeed, the ECB is a young central bank which, together with the national central banks in the Eurosystem, has assumed responsibility for a new currency, the euro, in a new economic and currency area, the euro area. Therefore it could not be taken for

granted that the euro would be able to establish itself so quickly as a stable and internationally recognised currency.

This was only possible because the ECB and the national central banks of the Eurosystem have solid institutional foundations. These foundations are the treaty negotiated in Maastricht in 1991 and the Statute of the ESCB. The Treaty and the Statute of the ESCB are clear: the primary objective of the Eurosystem is to ensure price stability. The ECB and the national central banks of the Eurosystem are independent so that they can pursue this goal. Neither the ECB, nor the national central banks, nor the members of their decision-making bodies may seek or receive any instructions from anybody. This applies to European as well as national institutions. They, for their part, are obliged to respect the principle of central bank independence.

The priority given to price stability and the independence of the central bank are the results of a long, historical learning process in monetary policy. It is theoretically well founded and empirically proven that independent central banks are better able to ensure low inflation rates than those which are subject to political influence. Independence guarantees above all that central banks can focus on securing price stability over the medium and long term and are not exposed to short-term political influences, or to vested interests' pressures.

In Germany the primary mandate of price stability and the independence of the central bank, as embodied by the Deutsche Bundesbank, have a long tradition. This tradition and the Statute of the Bundesbank – which also inspired other central banks' statutes in Europe – were one of the major forces behind the Treaty of Maastricht and the Statute of the ESCB. I have myself been the governor of the independent Banque de France during these ten years. The independence was granted in January 1994, five years before the euro. During these five years I was particularly proud that our primary goal, price stability, was reached in line with our definition – below 2% – and was fully compatible with price stability in Germany during the same five-year period. It can be said that, with the creation of the euro, the stability culture has been “Europeanised” and given the legal face of an international treaty

### ***European stability consensus***

The primary mandate of price stability and the independence of central banks as laid down in the Maastricht Treaty, are an expression of a stability consensus which has grown in Europe – even worldwide – in recent decades. There exists today a general awareness of the fact that stable prices are indeed a fundamental condition for sustainable economic growth and employment.

The priority for price stability as the primary objective of monetary policy as well as the independence of the ECB enjoy broad support from the people of Europe. In surveys of citizens throughout the euro area, an overwhelming majority regard price stability as an important goal. An overwhelming majority believe it important that the ECB and the Eurosystem are independent of governments in order to achieve this goal. This support from our fellow citizens in the Euro area matters greatly to the ECB. It shows that the stability consensus is overwhelmingly shared among the public to which, as an independent institution, we are ultimately accountable.

### ***The euro as a contribution to the completion of the single European market***

The guarantee of price stability for the now 329 million Europeans in the euro area is the main reason why the euro has been a success story in its first ten years. But it is not the only reason. Let me briefly mention another important reason: the introduction of the euro was an important contribution to the completion of the single European market. The advantages of the single market could be better exploited by the common currency. Trade and capital ties between euro countries have grown.

I'd like to mention a few examples:

- The cross-border trade in goods and services in the euro area has increased by about 10 percentage points in relation to GDP since the introduction of the single currency. This can be partly attributed to the euro. Trade between individual euro countries now accounts for about half of their total exports and imports. At the same time, extra euro area trade developed very dynamically as well. Increasing trade integration within the monetary union did not come at the expense of trade with third countries. Hence, there is no “fortress Europe”.
- The euro has promoted competition, price transparency and the convergence of prices, and has lowered transaction costs and eliminated exchange rate risk.
- The euro has boosted direct investment within the euro area. Mergers between companies in the euro area have risen noticeably.
- The euro has also led to a marked increase in cross-border security investments within the euro area. This is only one example of the contribution made by the single currency to the integration of the financial markets in Europe. It’s not over yet. The ECB and the Eurosystem strongly support a further integration of Europe’s financial markets.

These developments show that the euro is an important catalyst for the completion of the single European market. The logic of “one market, one currency” was a substantial impetus for monetary integration in Europe. It has proved to be correct.

### ***The euro, monetary policy and employment***

Priority for price stability, which is a necessary precondition for sustainable growth and employment, in the euro area did not come by any means at the expense of employment. This is reflected in a number again: between the introduction of the euro in 1999 and 2008, the number of persons employed in the euro area increased by more than 16 million. In the years before, from 1990 to 1998, the increase in persons employed was less than 6 million. These new jobs in the euro area were not created by the euro. There is no direct relationship because the change in employment is affected by many factors. But it is a confirmation that a monetary policy oriented towards price stability is fully compatible with job creation.

I would like to come now to my second question:

### **What is the role of the euro amid the current financial market turbulence?**

The question makes clear that the global environment in which we operate has completely changed in the past 18 months.

### ***Global financial market turbulence and the economic downturn***

We are currently in an extraordinary situation. It is marked by an intensification and broadening of the global financial market turbulence – in particular since September last year – and a sharp downturn in the world economy. The tensions have increasingly spilled over from the financial sector to the real economy. Their negative effects can be felt worldwide. Since the end of 2008 virtually all economies – both of the industrialised countries and the emerging markets – have been moving in the same direction. This considerably contributes to the scale of the present downturn.

This economic downturn has also affected the euro area. Foreign demand for exports from the euro area has fallen. Very low confidence and tight financing conditions have adversely affected domestic demand. On the basis of our current analysis, we see persistent weakness in economic activity in the euro area over the coming quarters. The financial market tensions have a further impact on the global and domestic economy. The economic prospects are still marked by an exceptionally high degree of uncertainty.

### ***Reaction of the ECB and European governments***

The ECB reacted quickly and flexibly to the financial market turmoil. On 9 August 2007 we were the first central bank worldwide to recognise the tensions on the money market and to take important steps in the context of our liquidity management. With a very flexible liquidity management we ensured that solvent banks did not get into difficulties because of liquidity constraints. This has been the case in particular since September 2008 after intensification of the financial turmoil, which led to a very sharp rise in tensions.

When reacting to the financial market turmoil, the ECB has always differentiated between liquidity management on the money market and its monetary policy stance ensuring price stability. We lowered the key interest rates when there was increasing evidence of inflationary pressures diminishing. The decline in the inflation rates is due mainly to falling commodity prices and a significant slowdown in economic activity. Against this background, the Governing Council of the ECB lowered the key interest rates by 2.25% between October 2008 and January 2009. This is an unprecedented reduction in such a short period. In this way we have taken account of the easing inflationary pressures in the light of the economic downturn.

The governments in Europe have also reacted rapidly, resolutely and in a coordinated way to the financial market upheaval: they have prevented banks from collapsing. And they extended a line of defence against a possible systemic solvency risk, especially through credit guarantees and recapitalisation measures. This prevented a systemic crisis and created a basis for fresh confidence. These efforts of the central banks and of the governments are aiming at permitting the banks to live up to their role in the economy by resuming lending to economic agents.

### ***Reasons for a medium-term economic recovery***

2009 will be a very difficult year. I have already said this on various occasions. I see however at least four reasons why we can be confident that the world economy and the industrialised nations will recover:

- The vigorous reactions of central banks and governments to the extraordinary situation – not only in Europe, but worldwide – will progressively produce their effects. They may not yet have been sufficiently taken into account in the expectations of private sector participants.
- The growth potential of the emerging market economies, for example, in Asia, is considerable. Their current deceleration of growth is temporary. Many of these countries have an enormous potential to develop domestic demand.
- Technological progress is very rapid and will continue and even accelerate. It is a major source of future long term growth.
- Prices for oil and other commodities have fallen sharply since mid-2008. Their rise was an important factor in the current economic weakness. Their present low levels will be an expansionary contribution to the global economy

For these reasons it seems to be a reasonable working hypothesis that after an exceptionally difficult 2009 we will see an economic recovery in 2010.

### ***Lessons of the financial market turmoil***

An economic recovery must not however be a reason for returning to “business as usual”. Lessons must be learnt from the financial market turbulence. This work is still under way. Many national, European and international institutions and bodies are discussing the conclusions to be drawn for the financial system. The global financial system must become

more resilient in order to avoid such episodes in the future. I would like to name three key words, which point to the need for change:

- **short-termism** in the financial sector. A far too short time horizon for many actors in the financial system has contributed, among other things, to an excessive risk appetite. That's why, for instance, the compensation systems and risk management of the banks need to be profoundly improved.
- The **transparency** of the financial markets. Full information on all institutions, instruments and markets of relevance to financial stability is of the essence.
- The **pro-cyclicality** of the financial system. In the financial system there is a tendency to accept excessive risks in good times. In a downturn, sharp movements occur in the opposite direction. Here, among other things, banks face the question of adequate capital requirements.

### ***Current developments and the euro's role***

Against the background of the current developments, let me say a few words about the role of the euro. The last few months have shown us an important advantage of the euro: in stormy seas it's better to be on a large ship than in a small boat.

In history – also in the economic history – it's always a speculation to ask “What if...?” I want to do it nevertheless, because there are very well-founded hypotheses. One such hypothesis is: in addition to the financial market turmoil, the banking sector problems and an economic downturn, there would most likely be severe currency upheavals in Europe without the euro. We would likely face strong, erratic fluctuations between Europe's national currencies.

I call to mind in this context the crisis in the European Monetary System in 1992 and 1993. It was triggered, among other things, by a difficult European and international environment. We saw sharp tensions between individual national currencies. This led to abrupt shifts in competitiveness between individual countries. The European Union's internal market and in particular the free movement of capital were subject to tension.

Without the euro we would be facing similar difficulties today. The central banks would be in demand as crisis managers on an additional front. The euro does offer protection from distortions in the currency field which would worsen the current situation already marked by the financial markets' turbulences and the global economic downturn.

The commitment to the single currency of its founding fathers was visionary and trailblazing. With the benefit of hindsight, we can see the introduction of the euro ten years ago as a prescient, forward-looking response by Europe to the challenges and risks of the present world.

I would now like to consider my third question:

### **What challenges lie ahead for the single currency?**

Despite all the achievements, this is not the time for complacency. There are important challenges. The most important and most direct is of course to tackle the financial market turbulence and the economic downturn. But there are also challenges which go beyond tackling the current situation. But they are related to it in part.

I would like to consider three challenges briefly: the securing of sound government finances, structural reforms in the euro countries and the expansion of the euro area.

### ***Securing of sound government finances***

Sound government finances are critical. They complement the ECB's stability-oriented monetary policy. They prevent the fiscal policies of one country in the euro area from having

negative effects on other countries. Beyond that, sound finances make a national economy more flexible. They are part of a growth-friendly environment.

The fiscal policies of the Member States should promote the smooth functioning of Europe's Economic and Monetary Union. The Stability and Growth Pact is the instrument to guarantee this. The Pact is the most important pillar in the economic union. It supports the monetary union.

The strict and credible implementation of the Stability and Growth Pact is essential. Against the background of the current economic developments, it offers the necessary flexibility. Shortfalls in tax revenues and additional expenditure arising automatically from the economic situation support the economy. Where there is room for manoeuvre, additional fiscal policy measures can be effective. They should be timely, targeted and temporary, and take account of the respective country-specific situation with regard to state finances.

Notwithstanding all budgetary measures for supporting the economy in the short term, we need to ensure the sustainability of fiscal policy in the medium to long term. Public confidence in the soundness of state finances must not be undermined as this would also impair the effectiveness of the economic policy measures. Therefore, "exit strategies" from the current fiscal stimuli should be already thought of.

### ***Structural reforms***

Structural reforms in the countries of the euro area are very important for two reasons in particular. They are necessary in order to enhance the flexibility and resilience of the euro area economy and to increase its growth potential. Such structural reforms relate to the markets for goods and services, and the labour market.

Reforms of the goods and service markets should strengthen competition and accelerate an effective restructuring. An example of successful reform is the telecommunications sector, where liberalisation has enhanced competition, increased the variety of products and lowered prices, to the benefit of consumers. Labour market reforms should have two goals: to promote appropriate wage-setting and to facilitate labour mobility – the mobility between sectors of the economy and between regions.

Flexible job markets are important particularly in a monetary union. Exchange rate adjustments are not possible in response to economic developments and changes in competitiveness. Therefore, wage policy in the individual countries bears a special responsibility. It largely determines labour costs and thus a country's competitiveness. It must take into account productivity, the employment situation and the competitiveness of the respective country. The relative cost competitiveness of the various economies in the euro area has to be monitored very closely.

The present situation should be a catalyst, pushing further forward structural reforms in the euro countries. The EU's Lisbon strategy – which aims to make Europe's economy more dynamic and competitive – and the completion of the internal market, for example in the services sector, are very important items on the European agenda which should not be forgotten in the present circumstances.

### ***Enlargement of the euro area***

Many of the challenges confronting the ECB are shared with other central banks, such as the US Federal Reserve System, the Bank of England and the Bank of Japan. These include overcoming the financial market disruption and the economic downturn. Over the longer term, there is globalisation, with the rise of emerging market economies such as China and India, the rapid advances in science and technology and the ageing of our population. All these phenomena affect the economic environment in which central banks conduct monetary policy.

The enlargement of the currency area for which we bear responsibility is a challenge specific to the ECB. No other central bank operates in an economic and monetary area whose expansion forms part of a structured integration process. No other central bank regularly integrates new institutions, as the Eurosystem does. With each addition to the euro area, the Eurosystem incorporates a national central bank in the “monetary team”, which consists of the ECB – the “captain” – and all the national central banks of the euro area countries.

The euro was introduced ten years ago into 11 EU Member States as a single currency. At that time, the euro area had 292 million inhabitants. Today it comprises 16 countries with a total of 329 million inhabitants. Over the past ten years, five new members have joined: Greece, Slovenia, Malta, Cyprus and, on 1 January of this year, Slovakia. Slovenia and Slovakia were the first former communist countries from central Europe to join. Their entry bears witness to their transformation over the past two decades.

The accession of five countries in ten years also reflects the openness of the euro area. We are not a “closed shop”. The euro area is open to all Member States of the European Union. To join, a Member State has to fulfil the Maastricht convergence criteria. These relate to inflation, long-term interest rates, exchange rates and state finances.

The sustainable fulfilment of the convergence criteria before introducing the euro is in the interest of the countries concerned and of the euro area as a whole. Countries should not introduce the euro without having first achieved the necessary economic convergence. A high degree of sustainable economic convergence is required, so that they can be integrated smoothly into the euro area.

The convergence criteria are thus an important part of the stability-oriented set of rules of Europe’s Economic and Monetary Union. The ECB and the European Commission report regularly on the extent to which EU Member States outside the euro area are meeting the criteria. They serve to maintain the credibility and functioning of Economic and Monetary Union.

## **Conclusion**

Ladies and gentlemen,

When we look back over the first ten years of the euro, then we can do this with satisfaction. The sceptical forecasts before its birth have not materialised. The euro is a historic achievement. Its first ten years have been a success. This is also seen, noticeably so, from outside our continent. Europe can be very proud of what it has achieved. The euro has brought many benefits but as I already said, this is no the time for complacency. We have many challenges to cope with in the years to come. Some are shared with the other important central banks in the world, like responding to the present economic and financial global situation and drawing all the lessons from the present turmoil. Other challenges are specific to the Eurosystem, like the completion of the single market with a single currency and a successful enlargement. The people of Germany as well as all 329 million fellow citizens in the euro area, can count on the ECB and on the Eurosystem. You can count on us to continue providing a solid and reliable anchor of stability and confidence. Particularly in the current environment both these elements are essential.

I thank you for your attention.