Miguel Fernández Ordóñez: A decade with the euro

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Conference "10th Anniversary of the entry of Spain into the EMU", Bank of Spain, Madrid, 27 February 2009.

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Let me first welcome you and thank you for being here today at the Banco de España headquarters for this conference commemorating the tenth anniversary of the creation of the Economic and Monetary Union (EMU), of which Spain was a founding member. I particularly appreciate Professor Rojo joining me here for these opening remarks. He was the architect of the enormous effort of persuasion and economic and monetary policy action that secured Spanish access to the Union. He was the Governor of the Bank from the signing of the Maastricht Treaty until 2000, when the project had become a reality and when, to many people's surprise, the Spanish economy had successfully completed a rocky road to convergence. A celebration like today's without the presence of somebody so closely involved in this project would have been incomplete. Thank you, Ángel.

For a country such as Spain, which has frequently been a late arrival at defining events in modern history, having been a founder member of this key project of European integration is a landmark. It demonstrates Spaniards' willingness and ability to contribute actively to European construction and, therefore, to the present and future welfare of its citizens. European integration is a dynamic project, permanently under construction, which is today facing up to the challenges of a global economic recession and an international financial crisis of proportions unseen in many years.

Over ten years ago, before the euro was created, there was an academic debate turning on the theory of optimal currency areas, which questioned whether a single interest rate and, therefore, a single monetary policy could possibly be appropriate for such diverse countries. Ten years after the birth of the euro those of us who joined EMU, and many of those who did not, acknowledge the enormous advantages of being inside the monetary union.

Today, the contribution of the single currency in lessening uncertainty for economic agents is clear. The enormous advantages of moderate inflation, of interest rates with a limited range of volatility and of the fact that companies need not consider the exchange rate when buying and selling in an area with almost three hundred and thirty million consumers, are obvious. The upshot is stability, which is a valuable contribution to growth, as we have seen in other, similar-sized monetary areas such as the United States, and we should build on it.

We should also celebrate the institutional success of the Eurosystem. The ECB has fulfilled the goal entrusted to it by the Treaty, of keeping inflation expectations anchored, even at very difficult times. And the Eurosystem is in itself a truly fascinating experiment. Those of us privileged to meet every fortnight in Frankfurt bear constant witness to the success of this undertaking, which is unique in the process of European construction.

The Eurosystem blends centralised and decentralised decision-making, reflecting perfectly the common European project. On one hand the ECB takes centralised decisions for three hundred and thirty million citizens who have the euro as their common currency, while on the other, the Eurosystem operates in a highly decentralised and co-operative manner. The National Central Banks are involved in many joint projects. But allow me to discuss one with which I have been closely concerned in recent years: the launch and design of *Target 2 securities* which, behind this singular acronym, is an ambitious project that will facilitate securities settlement throughout Europe. This platform is being designed and constructed by four central banks: Germany, France, Italy and Spain. Any pro-European would be most satisfied to see officials of the banks from these countries working together every day on a common project.

Critics of the euro, who are quite frankly a minority today, try to argue that the divergences observed across the Monetary Union members in terms of inflation and growth during its first ten years have been a problem.

But the figures are not on their side. Over the past decade, inflation and growth diversity among the EMU members has been very moderate compared with what had previously occurred. And compared with other regions, this diversity, though somewhat more persistent, has been on the same scale as the heterogeneity across the different US regions and states, being the United States an example of a monetary union of approximately the same size as the Euro zone, and whose viability is unquestioned. Nobody considers that these divergences would advise California to have a different currency from that of New York or Illinois. What's more, empirical evidence from EMU shows that national business cycles have, with economic and monetary integration, become more synchronised.

Admittedly, though, growth and inflation differentials that we should reduce have persisted over this period. However, the solution to this problem should not be sought by questioning what the euro can do to reduce these differences. Rather, we should determine what we should do with other policies to narrow them. This is so since monetary policy can do nothing. The best way in which it can contribute to boosting growth, employment and welfare is to keep inflation anchored for the area as a whole. If, as I stated, we are convinced of the enormous advantages of the Euro, not only in the political sphere but also in economic and social terms, the question to ask is what governments and national parliaments should do to entrench the euro further.

And it is here that many major tasks remain. The first, which was promptly identified, was to look after fiscal policy. The Stability and Growth Pact and all the efforts of the Eurogroup over the years to maintain a coordinated and disciplined fiscal policy have been vital and should be continued in the future. But in addition to continuing along these lines in the coming decade, efforts should focus on designing and adopting the necessary structural policies.

If we observe how these divergences are perceived in the different countries, we can gain insight into the importance of efforts to push through structural reforms. Many in Spain believe that the divergence problems witnessed in the Spanish economy in recent years are to do with the fact that certain euro area countries are lacking in dynamism and therefore have much lower growth potential than we do. And it's true. Spain has a higher degree of privatisation that makes its economy much more dynamic. Also, the weight of public spending in the economy is much lower. Advances in competition in many industries affords higher growth potential for Spain than for other euro area countries. The problem of being in an area with countries with lower growth potential is that when the ECB set its interest rates in the 2000-2004 period, it did so at a level which, though arguably high for these other countries, was very low for Spain. And that entailed higher debt, higher inflation and, therefore, a loss in competitiveness for our country.

But look now how such divergences are seen from the other countries. The EMU countries that are less dynamic and with lower growth potential think that they had to deal with higher interest rates than were suitable for them, owing to the fact that the more dynamic countries had a tendency for higher inflation than them. And this is also true. Both views are true.

The lesson we should all draw is that, on one hand, the less dynamic countries have their work in terms of structural reforms: more privatisation, more competition, a greater weight of the private sector in the economy, etc. to increase their growth potential. And, on the other, the countries with more inflationary tendencies should, as I said a couple of weeks ago in Zaragoza, pursue their own structural reforms, reforming labour institutions, the rental market, etc. so that increases in demand, arising from relatively low rates, cannot generate inflation.

The celebration of these ten years is taking place just as the global macroeconomic scenario has undergone a deep-seated change as a result of the financial crisis, leaving it covered in great uncertainty and powerful recessionary tendencies. Now, those who are against a single monetary policy underscore the uneven impact that changes in the world economy can have on euro area members, as these are deprived of the macroeconomic stabilisation instrument that national monetary policies provided.

Once again, this is not an argument against EMU but one in favour of accelerating structural reforms. But let us first highlight the huge benefits of EMU precisely in the current crisis. Can anyone imagine how the 16 euro area countries would have weathered the international financial storm had they retained their 16 currencies? Anyone can appreciate the scale and seriousness of the financial problems these countries would have faced had each one retained its currency.

Remember what happened in the early 1990s when the effects of the US recession took some time to be felt in Europe, but eventually did so with unusual virulence. Amid the serious challenges arising from German reunification, the lack of a coordinated monetary policy response on this side of the Atlantic then led to massive speculation against exchange rates and to a major foreign exchange crisis, which some did not hesitate to call the collapse of the European Monetary System. This speculation ultimately imposed enormous costs for all the countries involved. This will not happen again now.

At this time of enormous uncertainty, the key institution of the Monetary Union, the ECB, has reacted in an exemplary fashion. In the space of five months it has managed to reduce the Euribor from 5.3% to 2% through changes in monetary policy, despite the increases in spreads arising from the financial crisis. And it has further adopted a policy of unlimited liquidity provision, in coordination with other central banks, as illustrated by the agreements for liquidity provision in currencies other than the euro.

The other European economic authorities have also reacted forcefully to support the financial system, to safeguard its functioning and to stimulate the various economies. Amid these global difficulties, cooperation and coordination between national authorities, particularly in Europe and in EMU, is today more necessary than ever. Responses based on the adoption of measures designed from an eminently national standpoint are, as in the past, bound to fail. The response to the current difficulties assailing our economies involves more Monetary Union and more European Union.

Allow me to conclude by responding to the argument currently being aired in the press on the uneven impact of the crisis in different economies. As I have said, referring to the differentials observed in the past, this problem cannot be resolved by the ECB. It is for governments and national parliaments to adopt the structural reforms I mentioned earlier. Indeed, the crisis should in fact be taken as an opportunity to carry out all these structural reforms.

Weak growth potential, competitiveness and productivity problems, the need to find an ideal level of regulation and government intervention, and insufficient goods and labour markets flexibility are, to name but a few, some of the challenges that remain central to the welfare of Europeans and that should, therefore, continue to feature prominently on the political agenda. Beyond the short term, these are the factors that determine the relative economic performance of the various euro area countries.

National policies should work to increase the capacity of each national economy to adjust to adverse shocks and to promote productivity and the use of the different production factors. The longer the adoption of the necessary national policies is delayed, the greater the potential costs will be in the face of adverse events. As central bankers, it is for us to concentrate our efforts on maintaining price stability, providing the appropriate framework for sustained growth and increases in employment and welfare. But it is also for us to keep the economic authorities and social agents fully aware of the rules of play of a monetary union.

Clearly, this anniversary comes at a time of great complexity in the international economy, from which neither the euro area nor Spain are isolated. The challenges are great and the uncertainty very high. But it would be unfair not to acknowledge that the course of the common project over these past ten years offers sound grounds to maintain a reasonable degree of optimism about our ability to face them.

Thank you.