Yves Mersch: The euro – a credible currency?

Speech by Mr Yves Mersch, President of the Central Bank of Luxembourg, at the Luxembourg Financial Centre Conference, Shanghai, 28 September 2010.

*   *   *

Excellences, Ladies and Gentlemen,

It is my pleasure and honor to talk to such a distinguished audience this afternoon. I am very grateful to for this opportunity to exchange views on the credibility of the Euro and on the role of our respective currency areas for a more balanced global economy.

Let me start with the credibility of the Euro. If you ask me, who has been a member of the Governing Council of the European Central Bank (ECB) since its establishment in 1998, if the Euro was a credible currency, you will not be surprised that my answer is “Yes”.

The statement the Euro being a credible currency might be more surprising against the backdrop of the current economic and financial crisis. Especially, as it has doubtlessly affected not only the (global) economy but also the major institutions of the Euro area. Some outside observers even have prematurely forecasted its demise. Let me explain why these predictions are wrong.

Currently ongoing recovery in the Euro area

In the short term, the economic situation is improving. The Euro area and its single currency are recovering from the most severe recession since World War II at a pace which takes laymen and experts by surprise. Since mid-2009 economic activity has been expanding. Recently the recovery has gained momentum. Euro area real GDP increased, on a quarterly basis, by 1% in the second quarter of 2010.

Clearly, the Euro zone was hit hard by the Great Recession. In 2009, i.e. in the aftermath of the near meltdown of financial markets in September 2008, real GDP fell by 4.1% in the Euro area. As a consequence unemployment rates soared to beyond 9% the same year. Correspondingly, the free fall of energy prices and the decrease of economic activity slashed down inflation significantly in 2009, pushing the inflation rate even into negative territory for a couple of months.

More recently, price developments have somewhat normalized, staying in line with the ECB’s aim of keeping inflation rates below, but close to, 2% over the medium term.

Although, in line with the ECB’s projections recent data and surveys indicate a moderation of growth in the second half of this year in the Euro area as well as on the global level, I am confident that the positive underlying momentum is increasingly broader based and signals a self-sustaining recovery in the Euro area. In my view, therefore inside the Euro area the gradual pace of adjustment of the monetary policy stance, of the overall provision of liquidity and of its allotment modes can continue.

The Euro: sound track record in the first decade

In a longer perspective the performance of the currency union is far more flattering. Between 1999 and 2009 real per capita output in the Euro zone grew on average by 1.5% per year. This is a comparable order of magnitude to that in the US, despite higher overall growth rates in the US. Consumer prices developed in line with the ECB’s definition of price stability. In the eleven and a half years after the creation of the single currency the Harmonized Index of Consumer Prices (HICP) has risen on average by exactly 1.97% per year. The performance of the ECB in delivering price stability has beaten that of the former benchmark currencies, the Deutsche Mark and the Dutch Guilder.

High cost of fighting the crisis

Still, there is no scope for complacency. In recent months, Europe has demonstrated unwavering commitment to the unity and integrity of the single currency area. However, the fight against the financial crisis and the deep recession has not only been successful, but also very costly. Moreover, it has uncovered institutional weaknesses as has been the case in the history of most currency unions. In particular, it poses challenges to the sustainability of public finances. In the Euro area the government deficit climbed to 6.3% of GDP in 2009. This year the Euro area government deficit will peak at 6.6%, before declining only to 6.1% in 2011. The overall government debt is expected to amount to 88.5% of GDP next year. This is still below the level prior to the introduction of the Euro. But it is also an increase of more than 20% from the level before the crisis.

Although, it is not too comforting that other major currency areas are facing even more severe deteriorations of public finances, it is a matter of fact:

- In the US fiscal stimuli and rescue packages have resulted in the federal budget deficit widening to around 10% of GDP for the fiscal year 2009 – and it will probably stay at that level in 2010 and 2011. By consequence the government debt-to-GDP ratio in the US was about 84% in 2009. It is expected to rise to 102.5% by 2011.
- In the UK, the general government deficit widened to 11.5% of GDP in 2009, and it is expected to decline to only about 10% by 2011. Gross government debt-to-GDP ratio is expected to increase from 68.1% in 2009 to around 87% in 2011.
- In Japan, the general government fiscal deficit is projected to be between 6% and 7% of GDP in 2009, 2010 and 2011, respectively. The government debt ratio was about 189% of GDP in 2009, and is expected to increase to about 195% of GDP by 2011.

Restoring fiscal sustainability is key

Given the deterioration of public finance in the industrialized world in general and in the Euro zone in particular, it is of the essence to correct fiscal imbalances in many Euro area countries. Responsible fiscal management is the basis for balanced and sustainable growth. Stability-orientated fiscal policies will stimulate confidence of households, firms and investors. This confidence is the pre-condition for economic growth and job creation. Governments must therefore send a clear message to markets – a message of determination and commitment to sound macroeconomic policies and fiscal sustainability. Budget plans for 2011 and beyond should reflect the urgent need for credible consolidation strategies.

Remember the words of John Maynard Keynes in 1937, in the aftermath of the Great Depression: “Just as it was advisable for the government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy”.

Strengthening of the institutional framework

What is economically reasonable needs an appropriate institutional framework. Neither markets nor the Stability and Growth Pact (SGP) succeeded in ensuring fiscal discipline in a sufficient manner.

Therefore, the spirit of the SGP needs to be strengthened. Promising steps have been undertaken so far.

- The task force under the chairmanship of the President of the European Council, Herman Van Rompuy, proposed, first, a streamlining of national budgetary calendars in order to improve monitoring and correction at an earlier stage of decision making. The so called European semester will stress economic surveillance: the fiscal discipline of the SGP, the structural reforms in the long term vision program “Europe 2020”, and a new mechanism to prevent macro-imbalances which will be fully embedded in the surveillance cycle. The European semester aims at prior policy guidance and preventive budgetary surveillance, in time when these really matter and allow discussing common policy before the budgets are agreed at the national level. The European Semester cycle will start in January with an “Annual Growth Survey” prepared by the Commission, reviewing economic challenges.
- Second, the task force discusses a system of “smart sanctions” against countries in breach of the debt and deficit limits, in order to strengthen the SGP in a preventive phase. The commission will tackle its proposals tomorrow. These plans aim at imposing more automatic sanctions in a gradual way.

In order to prevent the built-up of imbalances leading to pressures on the fiscal stance and diverging situations weakening the effect of a single monetary policy, surveillance at the macro-economic level needs to be strengthened, especially as far as competitiveness is concerned. Within a single currency union, the relative competitiveness of economies mirrors the sustainability of national price and cost developments, the compatibility of national nominal trends with those that are appropriate for the monetary union as a whole. Proposals are due to October.

This institutional deepening in crisis prevention is completed by crisis management decisions. The set up of the European Financial Stability Facility (EFSF), a rescue fund which achieved “AAA” status by all major rating agencies, intended to this. The European System of Central Banks (ESCB) together with the Commission call for renewed efforts for more integrated financial and capital markets. The regulatory reform for banking should spur these efforts leading to a new European banking landscape. Luxembourg with its experience will assume its share and responsibility in this evolution.

Another institutional deepening has been approved by the European parliament last week. In the micro-prudential area three European risk agencies will be set up for supervision in banking, securities markets and insurance. They will be completed by a European Systemic Risk Board strongly supporting Central Banks in the area of macro-prudential surveillance, hitherto neglected.

Rebalancing and global cooperation

China has been affected by the global crisis, too, though in a more subtle way. The challenges are manifold.

First, China’s impressive growth story of the previous decade was mainly export driven. This approach led to the inflow of foreign capital, a huge current account surplus and a massive accumulation of foreign exchange reserves. Different from what could be observed in the past, China as a dynamic Newly Industrialized Country became the biggest net creditor to the rest of the world in general, and to the US in particular.

The economic rise of China and other Emerging Market countries has gone along with increased political presence and responsibility at the global level. China in this respect reassumes the role it had in the world economy throughout most of history.

Second, although the fiscal position of China was sound, other vulnerabilities have been disclosed. A growth model that is highly concentrated on exports is at risk when external demand drops sharply. A broadening of the macro economic policies would reduce this exposure. The growth model, thus, would become more sustainable.

Tackling this issue would also be a contribution to deal with global imbalances.

One step on this way for sustainable growth and an orderly rebalanced global economy could be the enhancement of social safety nets. A coherent system of reforms of social security, health care and pension schemes would reduce the need for precautionary savings of private households and could thus stimulate private spending. This holds in particular for the challenge of an ageing society. A shift from economic activity from the public to the private sector would be helpful in this respect, just like corporate governance and financial sector reforms, or a reflection on local government finance.

There are some encouraging indications that measures to increase household income, notably in rural areas, expected to feature prominently the new five-year plan starting in January 2010. This could be an important contribution to a broadening the Chinese economic approach, and to move to a more quality oriented growth.

Concluding remarks

I am convinced that cooperation between the major players in the world economy is crucial. To tackle global imbalances, each continent has to do its homework.

- For China, continuing the rebalancing process from external to domestic demand, from huge public enterprises to private enterprises, demographic ageing and dispersion are no less challenging. In such an environment the increased role of the Renminbi will be one part.
- The European Union must resume the path of institutional deepening. It needs less divergence and more structural reforms to enhance growth and employment. Also, enhanced stability in the financial sector is of the essence. We must furthermore strengthen the economic governance of the European Union with reforms designed to a stable Euro and strengthen the foundations for sustainable public finances. In such a surrounding the Euro can and will stay a credible currency.

To sum up, both economic areas have – to use the word of Premier Wen Jiabao who spoke recently in Tianjin – to undertake efforts to ensure, first, better balance, second, coordination and, third, sustainability of economic development.