Yves Mersch: Europe and the Euro – the way ahead

Speech by Mr Yves Mersch, Member of the Governing Council of the European Central Bank and Governor of the Central Bank of Luxembourg, at the OMFIF Investment Seminar, Tokyo, 28 July 2011.

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Ladies and Gentlemen,

It is my pleasure and privilege to talk in front of this distinguished audience about the challenges we face after the crisis.

Myths on the premature collapse of the euro are currently the prevailing topic of financial news. They do not withstand a reality check based on facts and figures. Rather, they show a lack of understanding how "Europe" works.

I am therefore particularly happy to share with you some reflections beyond the headlines on the European Union (EU) and the euro area.

Let me stress that the members of the Governing Council of the European Central Bank (ECB) are now in the purdah period, as the next Governing Council meeting will take place on 4 August. This means that nothing in what I will say is intended or should be interpreted in any respect in terms of future monetary policy.

The first 12 years of the Euro: the single currency has been a success

The euro is without doubt a success story.

The common currency unifies more than 330 million people in a region that is among the wealthiest and most developed of the world.

For more than 12 years, the ECB in Frankfurt, in close cooperation with national central banks – to include the Banque centrale du Luxembourg – secured its primary mandate to maintain price stability in the euro zone as a whole.

Price stability in the understanding of the ECB is given at a medium-term inflation rate below but close to two percent.

Monetary policy in the euro area has accomplished this mission: the average annual inflation rate in the first twelve years since the introduction of the euro was 1.97 percent.

Although the ECB has started from scratch, it secured the low yield curve of the formerly most stable currencies. Many Critiques had expected that the yield curve of the new Euro would be an average – and thus higher – of the former basket of different currencies.

This result is remarkable not least because the stability of the euro had to be defended against a series of shocks. Let me name a few:

1. Since 1999 oil prices increased sharply peaking at $147 per barrel in 2008;
2. Rising and volatile prices of food and commodities;
3. The internet bubble burst at the beginning of the new millennium ;
4. The events of 11 September 2001;
5. In September 2008 the collapse of former US investment bank Lehman Brothers triggered the most severe financial crisis since the Great Depression some eighty years ago.

The euro area in an international comparison

Price stability is a major contribution to sustainable growth and job creation. Indeed, other economic indicators stress that the euro area as a whole has been successful since its inception:

1. Growth in the euro area has been robust in the first 12 years. Adjusted for the differences in population development economic growth in the euro area and the United States in the last decade were roughly the same. The growth of per capita income in this period amounted in both currency areas, about one percent per year.
2. Since 1999, roughly 14 million jobs have been created in the euro area. In the U.S., by contrast, only eight million new jobs were created during the same period of time.
3. Public finances in the euro area as a whole are sound. Although the financial crisis has stressed government deficits and debt in the euro area, forecasts indicate that in 2011 the euro area fiscal deficit will be somewhat less than half of that of the US and Japan. The euro area as a whole is on track to bring the deficit to Gross Domestic Product (GDP) ratio below the 3 percent reference value by 2013 and to stop the adverse debt dynamics caused by the financial crisis.
4. Trade within the euro area and the EU is flourishing as well as the exchange of goods and services with the rest of the world. The euro area is the most open major economy in the world.
5. Some argue that the US economy was more homogeneous than the economy of the euro. But the dispersion of growth rates of real gross domestic product (GDP) between member states of the euro area is comparable to the differences in the states of the United States. The same holds true for the dispersion of inflation and unit labour costs (as an indicator of competitiveness). In short: Heterogeneity within the euro area and the United States have been quite similar over the past 12 years.

The current edge: robust economic recovery at temporarily elevated inflation levels

Incoming statistical data releases and survey-based indicators point towards a continued recovery of economic activity in the euro area, albeit at a slower pace. Looking ahead, euro area exports should be supported by the ongoing expansion in the world economy. Because of the favorable level of business confidence in the euro area, private sector domestic demand should contribute increasingly to economic growth. Benefits stem from the still accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system.

The most recent projections by the experts of the Euro system foresee the economy to grow between 1.5 percent and 2.3 percent for 2011 and between 0.6 percent and 2.8 percent for 2012.

In the last months, higher energy and commodity prices pushed the inflation rate in the euro area to relatively high levels. In the view of the ECB's Governing Council it is of utmost importance that the temporary rise in the inflation rate does not feed through into second-round effects in price and wage-setting behavior. This could lead to broad-based inflationary pressures.

Inflation expectations must remain firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2 percent over the medium term.

To defend this goal the ECB has increased its policy rate already twice this year, in April and July by a cumulated 50 basis points to the current level of 1.5 percent. By doing so, the ECB was the first major central bank in the world that hiked interest rates and proved its unconditional commitment to its primary mandate of securing price stability in the medium term and its independence.

Global liquidity: regional mandate facing global challenges

A more structural issue basically all central banks have to tackle is abundant global liquidity. To many scholars and practitioners "ample global liquidity" has been repeatedly used as one potential explanation for financial developments before the financial crisis – and again more recently.

"Ample liquidity" in this context is regularly associated with phenomena like stock markets rallies, low bond yields, rising commodity prices and real estate booms. For monetary policy these developments are in so far of importance as they might have an impact on both consumer prices, i.e. inflation, and asset prices, i.e. financial stability.

One can distinguish between monetary liquidity and financial market liquidity. Monetary liquidity is the ability of an economic agent to settle his transactions. Financial market liquidity describes the ease with which large volumes of financial securities can be bought or sold without affecting the market price.

From a central bank perspective monetary and financial market liquidity should not be seen in isolation. They are related and influence each other. For example, if the transaction costs of an asset decline, i.e. financial market liquidity increases, it is more likely that this asset will be included in a specific measure of money.

Similarly, if investors' funding increase, i.e. monetary liquidity is higher, this will probably increase financial market liquidity.

Monetary policy has to distinguish between the potential short and long term impacts of increased global liquidity.

In the short run, global liquidity can affect asset prices and as such indirectly domestic economic conditions. Wealth effects and international capital flows are possible channels. Furthermore, global liquidity may affect international commodity prices and the prices of these commodities can influence the terms of trade as they are used as inputs in production processes. Thereby, they can affect domestic prices of some goods.

Indeed, while commodity prices have retreated more recently, many are still close to historically high levels and have put some pressure to prices via the described channels. Interestingly enough, commodities – besides serving as consumption and intermediary production goods – can to a large extent be understood as assets, which can be traded on futures markets and/or hoarded for speculative purposes.

Also, with respect to consumer prices, empirical research has shown that national inflation is partly determined by global economic dynamics. Moreover, recent studies indicate that inflation in mature countries is "largely a global phenomenon".

At the current juncture, new sources of inflationary pressure may therefore emerge. Let me give some examples. The combination of dynamic economic growth, accompanied by accelerated inflation in emerging markets bears the risk that imported inflation will come to play a larger role in domestic price levels in the industrialized world. The recent increases in prices of certain agricultural products and raw materials may therefore be more persistent than currently assumed. The lagged effect of food prices could still add a layer of headline inflation

In other words: The disinflationary impact of globalization, from which the industrialized world has benefited in the last 20 years, could turn into an imported inflationary impact.

It seems reasonable that common global factors play an important role for domestic liquidity conditions. Empirical evidence suggests that global liquidity is affecting consumer price inflation. This is even more apparent for asset price inflation which is clearly reactive to global liquidity shocks.

The growing importance of the external environment does not mean that domestic monetary policy is powerless. By contrast, under a flexible exchange rate regime the effects of global

liquidity on domestic inflation can be overcome by active domestic monetary policy, in particular in the long run. An independent central bank is able to stabilize a well-defined index of domestic prices despite economic fluctuations, be they domestic or foreign in origin.

Nevertheless, the analysis of global liquidity should play a bigger role in central banking with regard to consumer prices but also asset prices. Let us recall that the so-called Jackson Hole doctrine – ignoring asset price bubbles during the upswing and clean up the mess by lose monetary policy after the bubble burst – has turned out to be one of the most expensive errors in economic thinking.

The ECB is particularly well prepared to face these challenges. With its two-pillar strategy that allocates an important role to the analysis of money and credit in its monetary analysis, the ECB has built up the necessary expertise to investigate and examine global liquidity with a perspective to maximize its information content for policy makers. This helps to full its primary mandate of price stability and is a major contribution to financial stability.

The international role of the Euro: broad acceptance in financial markets

Despite of the talks of a euro crisis the acceptance of the single currency on international financial markets has remained undoubted. The currency preferences for the Euro exhibited in 2010 showed a remarkable degree of stability.

1. The euro continued to be the second most important international currency with a regional focus.

   At 9.3 trillion USD global foreign exchange reserves reached a new historical high at end-2010. This mainly reflected interventions by emerging market central banks aimed at stemming off appreciation pressures on local currencies

   - In 2010 the share of the euro in global foreign exchange reserves remained broadly unchanged. Adjusted for valuation effects, the share of euro-denominated assets in global reserve portfolios with a known currency composition increased slightly to 26.3 percent from 26.0 percent at end-2009 at constant end-2010 exchange rates. This underscores that the euro continued to be the second most important global reserve currency.

2. In international bond markets, the share of the euro decreased slightly by around two percentage points. This was mostly due to negative net issuance of euro-denominated international bonds. Temporary factors such as lower funding costs in the US dollar market mainly contributed to this somewhat lower share of the euro.

3. In the turnover of foreign exchange markets the share of the euro increased by around one percentage point. This stresses the euro's use as an important regional vehicle currency. The relative importance of the euro also increased by almost half a percentage point in global derivatives markets such as OTC interest rate derivatives, and by around one percentage point when used in cross-border loans and deposits. When used as an invoicing currency in increased by around half a percentage point and five percentage points, respectively. With non-EU countries, however, trade invoicing patterns remained relatively stable.

   The trading volume in global foreign exchange markets rose to almost 4 trillion USD in April 2010 as compared to 3.3 trillion USD in April 2007.

In fact the Euro proved to be recognized as a safe haven currency. In a recent study the ECB found that the best predictor of a safe haven status is not the interest rate spread, as assumed in the carry trade literature, but rather the net foreign asset position, the country risk and external vulnerability. This confirms that macroeconomic fundamentals of the issuing country are an important determinant of "safe haven" currencies.

Sovereign debt crisis: the Greek challenge

Although the talks of a crisis of the Euro are misguided, there is no reason for any complacency. We are still in challenging times. Especially in Greece, the situation is fragile.

Athens has made remarkable progress in consolidating its public finances. Its population has to experience cuts, which are unprecedented in the post war European history. Nevertheless, an additional financial aid package was necessary including additional fiscal consolidation and privatization efforts.

- In this context, Euro area Heads of State and Government reaffirmed their commitment to ensure the financial stability of the Euro area last Thursday. Bold and important decisions were taken, which include:
- Euro area Heads of State and Government announced 159 billion Euros of new financial support for Greece that will consist of 109 billion Euros from the Euro area and the IMF. Financial institutions will contribute 50 billion Euros after agreeing to a series of bond exchanges and buybacks that will reduce Greece's debt burden.
- The interest rate on the loans will be reduced and maturities will be extended to up to 30 years with a 10-year grace period. These amended conditions will also be available for Portugal and Ireland.
- The European Financial Stability Facility (EFSF) will be more flexible – an amendment the ECB has suggested for quite a while. The EFSF will be empowered to buy debt across stressed euro countries on the secondary market. The fund can also aid troubled banks and offer credit-lines to countries that are not under a program to repel speculators.
- Euro area governments will guarantee any Greek debt offered as collateral during money market operations in case a temporary credit event might be triggered. That will enable Greek banks to keep refinancing themselves via the ECB without impairing the soundness of eligible counterparts.
- The Member States and the Commission will mobilize all necessary resources to provide exceptional technical assistance to help Greece implementing its reforms.

In this environment, Greece can return to a path of growth and debt sustainability, provided the reform and savings requirements of the troika to be implemented. This alliance of the International Monetary Fund (IMF) and EU Commission in liaison with the ECB developed a program for Athens that has been calculated by senior experts.

Two objectives are at stake: the return to growth and the sustainability of debt.

1. Greece can resume growth when its potential is released. And its potential is huge. There is a vast supply of solar and wind energy which can be exported to the energy demanding states in Northern Europe. Moreover, Greece could turn into a major transport hub between Europe and Asia. There are plenty of superb engineers among young Greeks longing for entrepreneurial challenges. Last but not least, Greece is one of the most attractive places in the world for tourism of many kinds. Reform and effort, however, are necessary to lift that treasure.
2. Debt sustainability requires a government to be able to repay its financial obligations at some point in the future. Therefore the government has to run primary surpluses in the future. These have to be sufficiently large to accommodate the cost of servicing the government's debt obligations, both at present and in the future.

   To put this challenge into perspective, lessons can be drawn from the experience of primary budget balances in EU Member States. Many of which have indeed achieved significant primary surpluses over extended periods of time. Several uninterrupted episodes of high annual primary surplus stand out:

- Finland maintained an average annual primary surplus of 5.7 percent of GDP over 11 years (1998–2008);
- Belgium sustained one at 5.4 percent of GDP over 11 years (1994–2004);
- The average primary surplus for Denmark was 5.3 percent of GDP over 26 years (1983–2008); Italy managed to generate an average primary surplus of 5.1 percent of GDP over six years (1995–2000).
- Overall, ten EU Member States (Belgium, Bulgaria, Denmark, Ireland, Spain, Italy, Luxembourg, Netherlands, Finland and Sweden) recorded uninterrupted episodes of primary surplus for ten or more years, the lowest average annual surplus per episode being 1.6 percent of GDP.
- In cumulative terms up to 2009, the primary balance surplus stood at over 50 percent of GDP in seven EU Member States (Belgium, Bulgaria, Denmark, Ireland, Luxembourg, Netherlands and Finland).

There are also lessons to learn from the Asian crisis in the 1990s. All Asian countries under stress at that time who engaged in an IMF program managed to return to creditworthiness and regained market access (with the exception of Indonesia). The programs called for endeavor and temporary restraint to the population of these countries. But finally they managed.

Both solidarity and stability-compliant economic and fiscal policy are needed. They are the two sides of a coin in a monetary union. I am confident that the respective players live up to their responsibilities.

Improving the institutional framework in Europe

As the EU is not a country with a central government but a union of sovereign states, it needs strong institutions to function. To quote Jean Monnet, one of the intellectual architects of European Unity: *"Nothing is possible without the people, nothing is lasting without institutions."*

This is even more important for the euro area as a monetary union. Because in a monetary union of sovereign states with the objective of a stable currency effective rules are required to prevent individual countries from generating negative spillover effects by their national policy. This would undermine the credibility of the currency.

As early as in 1989 the Delors report, a blueprint of the Monetary Union named after the President of the European Commission at that time Jacques Delors, stated that "*an Economic and Monetary Union could only operate on the basis of mutually consistent and sound behavior by governments and other economic agents in all member countries. (…) Uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the community.*"

The current sovereign debt crisis in three smaller euro area countries has disclosed several institutional weaknesses within the euro area and the European Union, respectively. But the current difficulties can also be seen as an opportunity for a further integration of the European Union. In the medium-term we must improve the institutional framework for the euro area. Europe has always made its greatest steps forward in times of crisis or at least difficult times.

Important steps have already been taken to tackle the disclosed institutional shortcomings of the existing economic governance framework. They apply to the fields of financial supervision, fiscal and economic sustainability and a crisis resolution framework.

1. Consolidated financial supervisory framework

Before the crisis, the regime for financial supervision in Europe was fragmented. National bodies which supposed to supervise cross-border banks had no effective tools to resolve conflicts. The EU level financial services committees could only give advice and issue non-binding guidelines and recommendations. The new consolidated supervisory framework, in place since the beginning of this year, reflects the single market in financial services:

- The European Supervisory Authorities (ESAs) are three authorities created for the European banking sector (EBA), insurance and occupational pensions (EIOPA), and capital markets (ESMA)
- The European Systemic Risk Board (ESRB) is developing the tools necessary to warn and, if appropriate, make recommendations concerning systemic risk. The ESRB constitutes the macro-prudential complement. It is chaired by the President of the ECB.

2. Reform of the Stability and Growth Pact

The Stability and Growth Pact (SGP) will be reformed to improve the surveillance of national fiscal policies and apply enforcement measures at an early stage to ensure fiscal sustainable:

- Less room for discretionary decisions and more "automaticity" in the application of the preventive and corrective arm of the Stability and Growth Pact (burden of proof)
- Rapid strengthening of national fiscal rules – to facilitate implementation of the Stability and Growth Pact
- Clearer rules for the reduction of debt, especially in euro area countries
- Earlier application of financial sanctions

3. Improved economic surveillance in Europe

The implementation of sound macroeconomic policies is the best insurance. A new macroeconomic surveillance framework will be established to check deviant behavior at an early stage, thus preventing fiscal imbalances before they emerge. Surveillance of competitive indicators is of the essence:

- New framework for the prevention and correction of macroeconomic imbalances
- Early warning indicators and economic analysis of countries to identify where imbalances might emerge,
- The European Council may make appropriate policy recommendations to the country.
- If serious macroeconomic imbalances are identified, the affected country must submit a plan to implement the recommendations.
- The application of such a plan will be monitored
- Possible financial penalties in case of serious macroeconomic imbalances and lack of implementation of the recommendations

4. Crisis management

Prudence and prevention are important. Yet another crisis cannot be excluded for good. Therefore, a permanent crisis management facility has been agreed upon, that builds on the

ad hoc stability facilities established in 2010 to dampen contagion and preserve financial stability.

- *Current crisis mechanisms*
  - The EU countries and the IMF granted Greece financial assistance of 110 billion Euros.
  - European Financial Stability Facility (EFSF): Special Purpose Vehicle of the 16 Member States of the euro area to provide assistance guarantees the member states of max. 440 billion Euro
  - Financial Stability Mechanism (EFSM): European Commission grants in the amount of max. 60 billion Euros.
- *Mechanism from 2013 on*
  - European Stability Mechanism (ESM): a permanent crisis-management institution designed to replace the EFSF and the EFSM in 2013.

Concluding remarks

Since its inception more than 12 years ago, the euro area has experienced an unprecedented level of price stability. Moreover, the economic performance in terms of per capita growth and job creation compares positively with other large advanced economies. This is mirrored by the high acceptance of the euro in international capital markets.

Therefore, the widespread belief of a premature end of the euro is unfounded.

Still, the management of a single currency remains more challenging in a union of sovereign states compared to a political federation with centralized responsibility for fiscal and economic policy.

I am confident though that Europe can overcome these challenges. Recent institutional reforms to reinforce the euro area economic governance are going in the right direction.

There can be no doubt, however that future steps for further European integration will be accompanied by a credible and stable Euro that deserves the faith of financial markets and international investors.

Thank you for your attention.