Mr Duisenberg considers the euro, the dollar and national economic policies: what room for manoeuvre?

Speech by Dr Willem F Duisenberg, the President of the European Central Bank, at the Euro, J+80 Conference in Paris on 25 March 1999.

The euro made its debut on the international financial markets at the start of this year. Its successful launch in the 11 countries which form the so-called euro area constitutes a milestone in the process of European integration. The introduction of the euro has created a single currency area which approximately matches the United States in terms of economic size, is the world's largest with respect to its share in total world exports and ranks second in terms of the size of its capital markets. Thus, the euro has had and will continue to have in the years to come a profound impact upon both the euro area and the world economy.

The launch of the euro has raised questions concerning the relationship between the exchange rate, the monetary policy of the ECB and the room for manoeuvre of national policy. For the purpose of today's discussion I would propose to break down this rather complex issue into three aspects: namely, the role of the exchange rate of the euro in the Eurosystem's monetary policy strategy, the ECB's view of recent developments of the euro exchange rate vis-à-vis the US dollar, and the relationship between the single currency in the euro area and the flexibility of macroeconomic and structural policies in euro area countries.

The role of the exchange rate in the monetary policy of the Eurosystem

The introduction of the euro implies a change in the role and the importance of the exchange rate in Europe. Considered individually, most euro area countries are exceptionally open economies. In 1997 the sum of their exports plus imports as a share of their combined GDP was 53%. By contrast, for the euro area as a whole, trade in goods, measured as exports and imports combined, is around 26% of GDP and thus only somewhat higher than that of the United States and Japan. Hence the importance of a certain movement in the euro exchange rate for domestic economic developments has become less compared with the same movement of the exchange rate of a national currency in the past. Nevertheless, through its effect on economic activity and prices, the exchange rate affects the outlook for price stability and thus still undoubtedly plays an important role in the monetary policy of the Eurosystem. Let me therefore elaborate on this role in some more detail.

The primary objective of the single monetary policy is the maintenance of price stability. Monetary policy will always be geared to this objective. Consequently, the monetary policy strategy of the Eurosystem does not embody an implicit or explicit exchange rate target or objective, since gearing monetary policy decisions to maintaining such an exchange rate target may, at times, conflict with the goal of price stability.

Consequently, the ECB subscribes to the view that the exchange rates are primarily the outcome of current and expected monetary, fiscal and structural policies as well as cyclical and other economic developments, rather than an objective or target of monetary policy. Exchange rate misalignments and excessive volatility often reflect macroeconomic imbalances and/or market uncertainties. Accordingly, stability-oriented macroeconomic policies pursued in a transparent manner are the best contribution that can be made by policymakers to fostering exchange rate stability. In other words, misalignments and excessive volatility should be contained by addressing their underlying causes. The Eurosystem's stability-oriented monetary policy strategy ensures that the single monetary policy makes the best possible contribution in this regard. By contrast, attempts to suppress exchange rate movements through direct targeting do not address,

by themselves, the underlying causes of misalignment. Monetary policy in particular cannot correct misalignments caused by structural or fiscal policies. They need to be addressed via other policy actions.

Moreover, in a world characterised by integrated and highly liquid international financial markets, there is serious doubt as to whether pegging or targeting exchange rates is feasible. The sophistication, depth and liquidity of today's financial markets make it increasingly difficult for a central bank to defend an exchange rate for a prolonged period. In addition, the experience with exchange rate coordination among the G7 countries shows that it has always been very difficult to agree on a common objective. Obstacles to exchange rate coordination were also experienced by some ERM member states. When during the late 1980s and early 1990s economic developments in some member states of the ERM diverged, their bilateral exchange rates came under pressure, and eventually the exchange rate bands had to be widened to ensure two-way risk for speculators. Some currencies were even forced to abandon the ERM. These experiences are now reflected in ERM II. ERM II has relatively wide standard fluctuation bands and the ECB has the possibility of suspending intervention and financing if these could impinge on its primary objective of maintaining price stability. ERM II is explicitly designed to foster convergence to the euro area of countries that have not yet adopted the euro.

For all these reasons, stable exchange rates of the euro are best served by stability-oriented policies that are consistent with economic fundamentals. In particular, exchange rate targets or objectives would be neither a substitute for a credible and stability-oriented macroeconomic policy stance nor a surrogate for a flexible response on the part of domestic markets.

Nevertheless, exchange rates affect the maintenance of price stability as they influence import prices and activity, and thereby consumer prices, in the euro area. Moreover, they reflect market expectations about future economic developments and policies. Furthermore, due consideration has to be given to the exchange rate of the euro against the background of the importance of the euro area in the international monetary and financial system.

Therefore, the ECB monitors exchange rate movements on an ongoing basis within its broadly based assessment of the outlook for price developments. The euro exchange rate is an integral part of the broad range of variables used by the Eurosystem to take its monetary policy decisions. The exchange rate is also monitored as it may be a channel for monetary policy transmission.

Clear exchange rate misalignments, although difficult to identify, would be a cause of concern for the Eurosystem. If prolonged, they might affect inflation expectations and distort economic activity as well as hamper the efficient allocation of financial resources. Although in the euro area these negative effects will be mitigated, as a result of the low degree of openness of the economy, they cannot be ignored altogether.

According to the Maastricht Treaty, the ECOFIN Council may formulate so-called general orientations for exchange rate policy. These orientations – and this is consistent with the above – shall be without prejudice to the primary objective of the Eurosystem of maintaining price stability. Therefore, the EU finance ministers, who are ultimately responsible for the exchange rate policy of the euro, agreed in December 1997 that they would only issue these general orientations for the euro exchange rate in exceptional circumstances, such as in the case of clear and persistent misalignments of the euro. Successful and credible stability-oriented policies should help prevent the emergence of misalignments in the future.

The ECB's view on the dollar exchange rate

Let me now share with you our views on the exchange rate of the euro against the dollar. The weakening of the euro vis-à-vis the dollar during January and February was mainly attributable to a series of economic data releases over this period, which were mostly relatively favourable as far as the US economy was concerned. The US economy surprised commentators with very positive data on employment and output. Over the same period data releases for the euro area were more muted.

It appears, therefore, that the recent developments of the euro exchange rate primarily reflect the previously unexpected strength of the US economy.

Therefore, the recent fluctuations of the euro exchange rate should not be considered overly dramatic. The exchange rate of the euro against the dollar is now comparable with the level at which the so-called synthetic euro was quoted against the dollar prior to September 1998. Moreover, long-term government bond yields of euro area member states continue to be lower than in the United States, also suggesting that investors believe in the stability of the euro.

The current euro exchange rate, therefore, does not hint at a misalignment or at a structural weakness of the euro. Moreover, there is no indication that financial markets doubt the credibility of the monetary policy of the Eurosystem. Nevertheless, we should keep in mind that the credibility of a currency is a precious but likewise fragile asset. The possibility cannot be excluded that increased uncertainty about the political support for a stability-oriented monetary and fiscal policy has contributed to the weakening of the euro. Through pursuing a stability-oriented monetary policy, the Eurosystem underscores the confidence that the world has in this young currency, the euro.

What flexibility is left to national governments?

I now turn to the final part of my talk. It is clear that euro area governments will continue to need flexibility in national policies to address country-specific developments. For example, they will need to be able to respond to asymmetric shocks, that by their nature do not affect all euro area countries equally, and to more deep-seated economic problems related to the structure of their economies. Clearly, following the introduction of the euro, the instruments of monetary policy and the exchange rate are no longer available to national governments for addressing country-specific developments. Therefore the need for flexibility in other policies at the national level is even more apparent than before. Such national flexibility will be necessary both to address short-term imbalances in demand and to deepen structural reform efforts with a view to improving the supply-side conditions of the individual euro area economies. National governments retain the principal ability to address both objectives as they retain control of fiscal policy and the capacity to undertake structural reform.

Responding to short-term imbalances in demand

Let us first consider the role that national governments continue to play in responding to short-term imbalances in patterns of demand. It is sometimes argued that the requirements of the Stability and Growth Pact will prevent national governments from using fiscal policy to address these imbalances. However, if implemented correctly and without undue delay, the contrary is true, as compliance with the Stability and Growth Pact provisions will allow sufficient room for manoeuvre. The centrepiece of the budgetary provisions to be respected by member states is the medium-term objective of a budgetary position close to balance or in surplus. Sound government finances are important to strengthen the conditions for price stability and for the strong and sustainable growth necessary to support employment growth. Moreover, if governments achieve

balanced budgets in normal periods of the cycle, they create a safety margin, sufficient to allow the operation of automatic stabilisers in the event of a slowdown, or in the face of unexpected shocks, without risking excessive deficits.

The problem at the moment is that in the euro area as a whole we are still far from reaching the target of balanced budgets in normal cyclical conditions. Substantial structural imbalances continue to restrict the flexibility of public sector budgets. In a number of countries, deficit-to-GDP ratios remain close to the 3% value set in the Treaty as a reference for excessive deficits, rather than the medium-term balanced or surplus position envisaged in the Stability and Growth Pact. Recent fiscal consolidation has been rather disappointing. A significant increase in overall deficits, for instance as a response to a decline in real GDP growth rates, could reverse the progress we have seen in recent years in reducing deficit-to-GDP ratios across the euro area. Moreover, in the case of a prolonged growth slowdown, it is quite possible that deficits will quickly reach excessive levels.

So it is clear that it is of the utmost importance that governments make structural improvements to their fiscal positions, as this would allow them to regain sufficient flexibility in their budgets and, most importantly, could effectively contribute to supporting stability and growth in the euro area. However, despite the desirability of achieving this room for manoeuvre swiftly, only moderate fiscal consolidation is currently envisaged for the medium term. A number of stability programmes are aimed at attaining the necessary flexibility only at a relatively late date, and this is on the assumption of sustained economic growth and low interest rates. It is important that we see a commitment from policymakers to ensuring the swift achievement of this aim or to going beyond the aims envisaged in these programmes once economic growth has picked up.

The role of longer-term structural reforms

The most important area where there is national flexibility is in relation to structural policies. Indeed it is arguable that many of the important challenges which face euro area countries can only be addressed through national policies in this area. As the March 1998 Convergence Report of the European Monetary Institute already identified, there is an urgent need for lasting policy adjustments arising from:

- high and persistent unemployment which is largely of a structural nature;
- demographic trends which are expected to place a heavy burden on future public expenditure; and
- the high levels of public debt, which will weigh on the current budgets of many member states until debt levels are reduced.

To start with the first long-term economic issue, I now turn my attention to the contribution that structural reforms to euro area labour markets can make to reducing the very high level of European unemployment. As I have done in my comparison of the euro with the dollar, let us again contrast the developments in Europe with those of the United States. In 1970 unemployment in the United States, at around 4%, was actually significantly higher than in most European economies. Since then, although there has been a marked variation in the US unemployment rate during the course of each economic cycle, there has been no apparent long-term trend, as the unemployment rate stood at 4.4% in January 1999. In contrast, average European unemployment has been on a steadily rising path. The unemployment rates in the United States and Europe appeared to have broadly converged by the early 1980s, and since that time the unemployment rate in the United States has been below the EU average. Even though the euro area unemployment rate fell last year, the January 1999 figure of 10.6% was more than double the corresponding US rate.

Looking at the latest unemployment rates around the euro area – which range from 2.8% in Luxembourg (January 1999) and 3.6% in the Netherlands (December 1998) to 17.8% in Spain (January 1999) – suggests that policies must be developed at the national level. What is needed appears to be national structural reforms to make sustainable reductions in unemployment rather than a boost to euro area aggregate demand. Moreover, making labour markets more flexible can also make it easier to cope with short-term imbalances in demand.

However, the situation in euro area labour markets is not uniformly bad. Some countries, particularly those with more flexible labour markets, more moderate wage increases and less discouraging tax and social security policies, have managed to avoid the trend of ever-rising unemployment. For example, the Netherlands, Ireland, Portugal, Austria and Luxembourg all currently show unemployment rates well below the euro area average. There are also examples of other countries with higher unemployment rates, such as Spain, that have begun to take steps to reform their labour markets and are now beginning to see tangible results. We can also look at some of the non-participating member states, such as Denmark and the United Kingdom, to see that high unemployment can be reduced through structural reforms.

The need for structural reform is widely recognised, for instance in the OECD Jobs Study and at the November 1997 Luxembourg European Council meeting, and some progress with new policy measures is already being made. First, there are 'active labour market measures' to provide education, training and work experience – particularly targeted at the long-term unemployed. Second, there are reforms to ensure that tax and social security systems make people significantly better off in work than out of it. Third, there are measures to ensure that low-productivity workers are not forced out of the labour market. These include reducing the burden of taxes and non-wage labour costs and making sure that minimum wage schemes and collectively bargained wage agreements take account of the need to preserve such jobs. I would also wish to add that, contrary to some suggestions, such policies do not amount to 'competitive devaluations', and structural reforms and wage moderation are no 'zero sum game'. They can help generate net increases in average employment and should not be criticised as 'wage or social dumping'.

The second long-term economic issue I should like to address today is the need to prepare for the substantial financial consequences of the ageing of European populations. On the basis of current trends in birth rates and life expectancy, unfunded public pension and healthcare schemes generate very high implicit government liabilities in most euro area countries. Indeed, in many cases these implicit liabilities appear to be of such magnitude that they dwarf even the large official government debt levels. Unless action is taken quickly, these financial burdens will fall on future generations of taxpayers and may also threaten the soundness of government finances. Therefore, to prepare for the ageing of the population, substantial savings need to be made.

The third key issue is the need to make progress in reducing the high government debt-to-GDP ratios that have substantially increased over the past two decades. Whilst there was some improvement in the run-up to the start of EMU, the recent progress has been disappointing as the average debt-to-GDP ratio for the euro area fell only slightly to 73.8% in 1998, compared with 74.6% in 1997. Such imbalances are undesirable and can also have wider implications for the conduct of monetary policy. If there are any doubts about the soundness of fiscal policies, this can influence the effectiveness of monetary policy instruments, and undermine the credibility of monetary policy.

In addition to the long-term economic issues mentioned so far, I should also like to emphasise that the structural reform agenda available to national governments to promote economic development extends well beyond the reform of labour markets and public finances. For example, national governments can take steps to promote entrepreneurship and make it easier for people to

start and run businesses and thus create new jobs. This could involve encouraging competition through measures to promote the entry of new firms, such as reducing the administrative burdens they face, making markets more competitive and facilitating access to venture capital. Governments can also liberalise previously highly regulated sectors, such as utilities, to increase efficiency and reduce prices to the benefit of industrial and household users of these services. National governments may also wish to take steps to raise productive investment in research and development to increase growth in expanding high-tech industries.

The introduction of the euro and a common monetary policy has certainly not rendered national governments impotent. With the ability to vary fiscal policy and undertake structural reforms, national governments retain the key powers to address the real needs of their economies. If the terms of the Stability and Growth Pact are adhered to, then there is sufficient flexibility to allow automatic stabilisers to work in the event of a slowdown. Structural reforms provide the only means of achieving lasting reductions in unemployment, preparing for the ageing of the population and reducing the burden of government debt. National governments would be well advised to press ahead with such reforms. Apart from having their own merits, such policies would also support the ECB in maintaining price stability in the euro area.