

Mr Duisenberg outlines the benefits of European Monetary Union, growth and stability for Europe

Speech by the President of the European Central Bank, Dr W F Duisenberg, at the Global Economy conference organised by the Economic Strategy Institute in Washington, D C on 27 April 1999.

Introduction

Following almost a decade of meticulous preparation and economic convergence, 1 January 1999 saw the start of Stage Three of Economic and Monetary Union (EMU), with the introduction of the euro and a single monetary policy for the euro area. This area constitutes an economic region that roughly equals the United States in terms of both its economic strength and its degree of macroeconomic openness. The euro area has a population of 292 million, which is slightly larger than that of the United States, at 270 million, and a somewhat smaller GDP of EUR 5,800 billion compared with the EUR 7,600 billion of the United States. As will be clear from these figures, the euro area economy is of a formidable magnitude, and indeed is one of the largest economies in the world, with a purchasing power matched only by that of the United States. It is my conviction that EMU has the potential to stimulate further the growth of the euro area economy and to increase the prosperity of its participants. At the same time, a successful EMU is also in the interest of the United States and the world economy in general, creating opportunities for trade, direct and portfolio investment.

Before I address the benefits of EMU and the stability-oriented policies that have to be implemented to ensure that these benefits are achieved, let me briefly mention the main institutional bodies involved in the formulation and implementation of the single monetary policy. Monetary policy is determined by the Governing Council of the European Central Bank (ECB), which consists of the eleven governors of the national central banks (NCBs) of the participating Member States and the six members of the Executive Board of the ECB. The implementation of the single monetary policy is the responsibility of the Eurosystem, which is comprised of the ECB and the eleven NCBs of the participating Member States. The Executive Board of the ECB is a separate decision-making body. Its role is to ensure that the tasks conferred upon the European System of Central Banks (ESCB) are implemented, either through its own activities or through the NCBs.

Economic growth - the benefits of EMU

I should now like to address the benefits of EMU and why I believe that the introduction of the euro and the single monetary policy can result in higher economic growth in the euro area and thereby contribute positively to the development of the world economy. Of course, the degree to which these benefits are achieved depends not only on the monetary policy of the Eurosystem but even more so on accompanying stability-oriented fiscal policies and appropriate labour market policies.

The most important contribution that the Eurosystem's monetary policy can make to maximising the benefits of EMU is to fulfil its primary objective of maintaining price stability, as laid down in the so-called Maastricht Treaty; the Treaty on European Union. As has long been argued by central bankers and is increasingly accepted by academic economists, inflation and deflation are economically and socially costly. EMU is a tool with which to consolidate the progress made towards price stability in recent years and to firmly anchor expectations in line with price stability, thereby establishing the framework necessary to fully exploit the opportunities of Monetary Union. The Eurosystem enjoys full independence in determining the appropriate level of interest rates so as to satisfy its primary objective of price stability. Moreover, the members of the Governing Council of the ECB have long terms of office and may only be dismissed on grounds of serious misconduct or inability to perform their duties. These provisions imply that the concept of monetary stability benefits from explicit legal protection.

A further important benefit of EMU is that it has removed the risk of serious real exchange rate misalignments within the euro area. This contributes to economic growth and helps to avoid any misallocation of resources. In fact, it enables the European Single Market to function smoothly and thereby makes it possible to reap all the rewards, to the benefit of producers and consumers.

Furthermore, the start of Stage Three of EMU has also eliminated short-term intra-EU exchange rate volatility and exchange rate risks, and has thereby encouraged trade and investment.

In addition, the benefits of economic integration afforded by the development of the Single Market are enhanced by the elimination of the transaction costs of exchanging different currencies, a direct result of the introduction of the euro. While they are difficult to measure, they effectively form an additional layer of protection for domestic producers. The single currency makes prices across the euro area directly comparable, which should increase competition and hence efficiency and economic growth in the area.

A number of further positive effects on economic growth flow from the elimination of separate currencies in the euro area countries. One benefit is the potential for the reduction of risk premia built into real interest rates, which, in turn, will stimulate productive investment. Another benefit is that by facilitating the development of deep and integrated capital markets, the single currency should further reduce long-term rates via the elimination of an illiquidity premium. In addition, a wider and deeper capital market in the euro area will improve intermediation between savers and investors.

Ensuring the benefits: stability-oriented policies

It should be emphasised, however, that the true benefits of EMU derive from the fact that it is a unique opportunity to shape a macroeconomic environment conducive to stability, growth and employment, and to foster structural change which is needed to maintain or restore medium to long-term dynamism in the European economies. It will be clear that this is not an easy process and monetary policy alone cannot achieve this. The full benefits of the single currency will come only if there is appropriate support from other stability-oriented policies, especially fiscal and labour market policies, and if structural reforms are carried out in these areas. Thus, price stability is a necessary, but not a sufficient condition for grasping all the opportunities of EMU.

In this regard, it is of the utmost importance that the governments of the EU Member States continue to implement sound and stability-oriented fiscal policies, by which I mean policies aiming at the medium-term objective of a budgetary position close to balance or in surplus. As you will know, this condition is stipulated by the Stability and Growth Pact, which ensures the lasting compliance of fiscal policies with the requirement of budgetary prudence. From the perspective of a central banker, a prime reason for the establishment of the Pact was that a lack of fiscal discipline would negatively affect the ability of the Eurosystem to achieve its primary objective to maintain price stability. In this sense, the Stability and Growth Pact is one of the most important safeguards that will ensure that price and fiscal stability remains the cornerstone of EMU.

Therefore, it should be clear that I regard it as crucial for governments to make further 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. In this regard, I should like to note that only moderate fiscal consolidation is currently envisaged for the medium term. A number of national stability programmes only aim to attain the necessary flexibility at a relatively late date. It is important that we see a commitment from policy-makers either to ensuring the swift achievement of this aim or to going beyond the aims envisaged in these programmes once economic growth has picked up.

Let me turn now to the contribution that stability-oriented structural reforms, particularly of euro area labour markets, can play in reducing unemployment and in supporting the stability of the euro. The high level of European unemployment is quite rightly a source of deep concern and should be addressed at a fundamental level. Clearly, the approaches that are most likely to have a lasting effect are those that address the root causes of the problem, not just the symptoms. The root causes of high unemployment in the European Union are structural rigidities in the labour market as well as tax and public transfer policies. This view is supported by a wide body of academic literature and was also a key finding of the OECD Jobs Study. It is obvious that structural problems require structural solutions. Implementing an inflationary monetary policy would not result in lasting reductions in unemployment, but would actually serve to exacerbate the problem over the medium term.

I recognise that structural reforms are not always easy to implement. The benefits are often enjoyed in the medium term, while short-term costs for some groups may mean that reforms are vigorously opposed by interest groups. Although there is a common objective of reducing unemployment, there is no common programme of reforms that will work in all countries. While it is possible to learn from the experience of others, each Member State will wish to develop workable policies that reflect its own particular circumstances. Although the path of structural reform is not always an easy one, it is the only way in which we can achieve the lasting reductions in unemployment that are so urgently needed. Only structural reforms that aim to create stable labour markets in which there is flexible interaction between supply and demand will ensure that the benefits of EMU in terms of economic growth are achieved to the maximum extent possible.

Conclusions

To conclude, Economic and Monetary Union provides a great opportunity to create and maintain a large zone of price stability and economic prosperity in Europe. However, while price stability is a necessary condition for fully grasping the opportunities of EMU, it is not, in itself, sufficient. Stability-oriented policies regarding the development of national fiscal positions and the functioning of labour markets are also of crucial importance. As I have explained, the benefits of EMU will not come in a quasi-automatic way. While monetary policy will make its contribution by following policies that maintain price stability, other economic policies must be implemented to ensure that the opportunities of the single currency are achieved. Monetary policy alone - however well designed and implemented - cannot solve Europe's economic problems. Policy-makers in all areas must be determined to take proper account of the new environment of Stage Three of EMU and its consequences when forming their policies.