Mr Noyer focuses on the benefits of EMU and on the euro as an accelerator for economic growth in europe

Speech by Christian Noyer, Vice-President of the European Central Bank, at the lunch-meeting of Cercle d'Union Interalliée in Paris on 23 June 1999.

Introduction

On 1 January of this year, the euro was introduced in 11 countries (EU-11 countries) with a total population of almost 300 million. The start of Stage Three of Economic and Monetary Union (EMU) established a combined economy that is only slightly smaller than that of the United States. So, both in human and economic resources, the euro area can be compared with the largest economy in the world. Furthermore, eventual participation of the four countries which have not yet adopted the single European currency – Denmark, Greece, Sweden and the United Kingdom – would only further enhance the economic weight of the euro area and promote the contribution of Europe to world economic development. In this sense, the euro is truly an accelerator of economic growth, as the use of the same currency in the euro area will increase cross-border competition and market integration, thereby enlarging economic prosperity for European citizens that will spillover to other European and non-European countries as well. It is my conviction that EMU could be a catalyst for economic progress in Europe, and could fundamentally re-shape the contours of the world economic order in the 21st century. Today I shall deal with the benefits of EMU and the stability-oriented policies that have to be implemented in order to reap the full potential of EMU. Making EMU a success is a process which requires the efforts of all of us.

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 should result in higher economic growth in the euro area and thereby contribute positively to the development of the world economy. 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 and appropriate labour market policies. When speaking of the Eurosystem, I refer to the European Central Bank (ECB) and the eleven national central banks (NCBs) of the participating Member States.

The most important contribution that the Eurosystem's monetary policy can make towards exploiting to the maximum the benefits of EMU is to fulfil its primary objective to maintain price stability, as stipulated in the Treaty on European Union. As has long been argued by central bankers and academic economists, inflation is costly, both economically and socially.[1] Nobel prize-winner Milton Friedman expressed this well in 1980, when he said : "Inflation is a disease, a dangerous and sometimes fatal disease, a disease that if not checked in time can destroy a society"[2]. The same could be said about deflation. In my view, EMU is a tool to consolidate the progress made towards price stability in recent years and to firmly anchor expectations in line with price stability, and thereby establish the necessary framework to seize the opportunities of monetary union. The Eurosystem enjoys full independence to determine the appropriate level of interest rates in order to satisfy its primary objective of price stability. Moreover, the members of the ECB Governing Council have long terms of office and are only dismissible for serious misconduct or inability to perform their duties. These provisions imply that the concept of monetary stability benefits from explicit legal statutes and that the credibility of the Eurosystem will be safeguarded by protecting the monetary policymaking process from political interference.

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[1] S. Fisher, "Why are central banks pursuing long-run price stability?," revised version of a paper prepared for the Federal Reserve Bank of Kansas City Symposium (Achieving Price Stability), August 1996.
[2] M. Friedman and R. Friedman, *Free to Choose: A Personal Statement*, Harcourt Brace Jovanovich, 1980, p.253.

A further important benefit of EMU is that it has greatly reduced the risk of real exchange rate misalignments within the euro area. This fosters economic growth and avoids a misallocation of resources. In fact, it enables the European Single Market to function smoothly to the advantage of producers and consumers. EMU has eliminated nominal exchange rate volatility and exchange rate risks within the euro area. This benefits not only trade between, and economic growth in, the euro area countries but also the economic development of other European and non-European countries. In addition, foreign direct investments into the euro area economies should be promoted, as these investments are negatively affected by exchange rate volatility.

The advantages of economic integration afforded by the Single Market process are enhanced by the elimination of the transaction costs of exchanging different currencies, the direct result of the introduction of the euro. Furthermore, the single currency will make prices across the euro area directly comparable, which should increase competition and hence efficiency and economic growth in the euro 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. This in turn will stimulate investment. By facilitating the development of deep and integrated capital markets, the single currency should further reduce long-term rates via the elimination of premia resulting from less liquid markets. For example, empirical research has shown that due to more liquid markets, US long-term interest rates are 25 to 50 basis points lower than comparable European interest rates[3]. In addition, a wider and deeper capital market in the euro area will improve intermediation between savers and investors.

Finally, EMU may stimulate further political integration of Europe. In general, the process of European integration has been driven and continues to be driven by the political conviction that an integrated Europe will be safer, more stable and more prosperous than a fragmented Europe. In this sense, the introduction of a single currency in the euro area could become an important symbol of political and social integration in Europe. It could serve as a catalyst for further integration in other areas.

Ensuring the Benefits (I): A Stability-Oriented Monetary Policy

As I mentioned earlier, the most important contribution of the Eurosystem's monetary policy to economic growth in the euro area is achieving its primary objective of maintaining price stability. The specific way in which the ECB should pursue this primary objective is laid down by what is called the monetary policy strategy. I should like to address now the main aspects of the Eurosystem's strategy.

First, in order to guide expectations of future price developments and to facilitate the public's assessment of the success of the single monetary policy, the Governing Council of the ECB has announced a quantitative definition of its primary objective. That is, price stability has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term.

Second, to maintain price stability according to this published definition, we have chosen a distinct monetary policy strategy, one that reflects the special circumstances that exist at present as well as those likely to prevail in the foreseeable future. It ensures as much continuity as possible with the strategies previously pursued by the NCBs. At the same time, it gives due consideration to the unique situation that prevails in the early years of the introduction of the euro. Our strategy rests on two

[3] G. Alogoskoufis, R. Portes and H. Rey, "The Emergence of the Euro as an International Currency", 1997, as discussed in A. Bénassy-Quéré, B. Mojon and A.D. Schor, The Role of the Euro, CEPII, document de travail no. 98-03, January 1998.

“pillars”: a prominent role for money as expressed by the announcement of a reference value for the annual growth of M3 and a broadly based assessment of the outlook for price developments, and the risks to price stability in the euro area as a whole.

In the context of the first pillar of the monetary policy strategy, the Governing Council of the ECB has announced a quantitative reference value for the growth of a broad monetary aggregate (M3), which has been set at an annual rate of 4½%. Under normal circumstances, substantial deviations from the reference value would tend to indicate future risks to price stability. However, monetary policy does not react to deviations of monetary growth from the reference value in a “mechanistic” way. In the first instance, such deviations will be thoroughly analysed to infer any signals which they may send about the prospects for price developments. If this analysis points to a threat to price stability, monetary policy will react in a manner appropriate to counter this threat, rather than attempt to eliminate the deviation of monetary growth from the reference value in the short term.

Although monetary data contain information which is vital for monetary policy decision-making, monetary developments alone will clearly not constitute a complete summary of all the economic information necessary to enable appropriate policy decisions to be taken. That is why it is important to monitor simultaneously a wide range of financial and other economic indicators, including economic forecasts. This broadly based assessment constitutes the second pillar of our monetary policy strategy.

All in all, the combination of the two pillars of the Eurosystem’s strategy ensures that monetary, financial and economic developments are closely monitored and analysed. On the basis of this thorough analysis, the interest rate will be set in a way that best serves the maintenance of price stability.

Ensuring the Benefits (II): Stability-Oriented Non-Monetary Policies

Let me now turn to the importance of prudent and stability-oriented non-monetary policies in order to reap the fruits of the single currency. I should like to emphasise that the true benefits of EMU derive from the unique opportunity to shape a macroeconomic environment conducive to stability, growth and employment, and to foster structural change which is needed to maintain medium to long-term dynamism in the European economies. The full benefits of the single currency will arise 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.

As regards fiscal policy, it is of the utmost importance that the governments of the EU Member States pursue in implementing fiscal policies that aim at a budgetary position close to balance or in surplus. This condition is stipulated by the Stability and Growth Pact, to ensure 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 is that a lack of fiscal discipline would negatively impact on the Eurosystem’s policies to maintain price stability. Let me elaborate on this. The institutional framework of EMU and the Eurosystem has been designed so as to prevent any direct link between an increase in public sector deficits and a monetary expansion, and thereby inflation. This is ensured by assigning to the Eurosystem the primary objective of price stability, banning direct financing of government deficits by central banks and precluding any influence by governments or other institutions on monetary policy decisions. However, even in this setting, the conduct of fiscal policies has a clear bearing on the objective of price stability. In particular, doubts about the soundness of fiscal policy can influence the effectiveness of monetary policy instruments and undermine the credibility of monetary policy.

For decades – and until very recently – fiscal policies have followed a trend of ever-growing public sector and government debt levels. In EMU, without binding fiscal rules, countries might have even less incentive to pursue prudent fiscal policies. The main reason is that risk premia offsetting inflation and exchange rate expectations disappear on a country-specific basis and may not be fully outweighed by default risk premia. Hence, the Treaty establishing the European Community contains a number of provisions on the conduct of fiscal policies, which have been further clarified by the Stability and Growth Pact. In this sense, the Stability and Growth Pact is an essential safeguard to ensure that price and fiscal stability remain the cornerstones of EMU. Therefore, we attach great importance to the implementation of this Pact.

It is a misunderstanding to believe that the Stability and Growth Pact is imposed on countries only as a price they have to pay for entry into EMU. In fact the Pact just stipulates what had to be achieved in any case, with or without EMU. The need for addressing budgetary imbalances is clear, in particular, from the costs associated with the ageing of the population, which will soon require additional budgetary room for manoeuvre. According to long-term projections and estimates, current trends in birth rates and life expectancy, together with unfunded public pension and health care schemes, result in very high implicit government liabilities in most euro area countries. In many cases these implicit liabilities appear to be far in excess of official government debt levels.

Let me turn now to the contribution that 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 rightly a source of deep concern. Clearly, the approaches that are most likely to have a lasting effect are those that address the root cause of the problem, not just the symptoms. The root causes of high unemployment in the European Union are structural rigidities in labour markets 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.

The underlying structural nature of the European unemployment problem can be seen most strikingly if one compares developments in Europe with those in the United States over the last three decades. In 1970, the unemployment rate in the United States, at around 4%, was at least twice as large as that prevailing in most European economies. Since 1970 there has been significant cyclical variation in the unemployment rate in the United States, but no upward trend. At 4.2% in May 1999, the unemployment rate in the United States is almost the same as it was in 1970. In contrast, average European unemployment appears to have risen with each passing economic cycle. By the early 1980s the unemployment rates in the United States and Europe had broadly converged. Since then the unemployment rate in the United States has been below the average for the European Union. Despite recording some decline last year, the euro area unemployment rate was 10.4% in April 1999, more than double the corresponding rate in the United States. However, some European countries, particularly those with more flexible labour markets, have managed to avoid the trend of ever-rising unemployment. For example, the Netherlands, Ireland, Portugal, Austria and Luxembourg at present have unemployment rates well below the euro area average.

If one examines the duration of unemployment, it is immediately apparent that Europe’s problem is principally one of long-term unemployment. According to OECD figures, around half of the unemployed of the European Union has been out of work for at least a year, while in the United States, under 10% of the unemployed have been without work for this long. This suggests that in Europe there is an urgent need to improve incentives aimed at getting the long-term unemployed back to work.

There are many good examples of what can be done - and is currently being done in some euro area countries – in terms of structural reforms. First, there are measures to ensure that low-productivity workers are not forced out of the labour market. To this end, the burden of taxes and non-wage labour costs could be reduced for low-paid workers. In addition, minimum wage schemes and wage agreements reached by collective bargaining need to take account of the need to preserve jobs for low-productivity workers by reducing labour costs. Second, there are “active labour market measures” which provide programmes of education, training and work experience targeted at the long-term unemployed. Third, reforms to the tax and benefit systems could be implemented which ensure that people are significantly better off in work than out of it.

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 required. Only structural reforms that aim at stable labour markets where supply and demand meet in a flexible way will ensure that the benefits of EMU for economic growth are really achieved.

Conclusions

I am convinced that Economic and Monetary Union provides a great opportunity to create and maintain a large zone of price stability and economic prosperity in Europe, including a substantial reduction of unemployment. However, while price stability is a necessary condition for fully grasping the opportunities of EMU, it is not in itself sufficient. Stability-oriented polices regarding the development of national fiscal positions and the functioning of labour markets are of crucial importance as well. As I have explained, the benefits of EMU will not arise in a quasi automatic way. While monetary policy will deliver its contribution by following policies that maintain price stability, other economic policies must be implemented to ensure that the opportunities of the single currency will be fully utilised. Monetary policy alone - however well designed and implemented - cannot solve Europe’s economic problems. Policy-makers in all areas must be determined to take the new environment of Stage Three of EMU and its consequences appropriately into account when forming their policies. Only then will the euro be able to function as a truly accelerator of economic growth in Europe.