Evolution of EMU

Federal Reserve Bank of Philadelphia

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Introduction

Let me say at the outset how delighted I am to be invited to address such a distinguished gathering. I am grateful to Bill McLoughlin, in his capacity as President of the Irish American Business Chamber and Network and Board member of GIC, for affording me the opportunity to speak on a topic that is close to the heart of European central bankers. And I would also like to thank Tony Santomero for hosting the discussion and lunch: as a member of the Governing Council of the ECB, I am deeply conscious of the excellent relationship which the ECB has enjoyed with the Fed under the chairmanship of Alan Greenspan and I am fully confident that we can look forward to a similar relationship with Ben Bernanke.

What is EMU?

Permit me to start by mentioning three general points on EMU: **first** EMU relates to twelve countries which have come together to form a monetary union. It is roughly equal to the US in terms of population, with a GDP per capita that is 70% that of the US, a somewhat lower fiscal deficit and inflation, but a level of unemployment that is considerably higher. **Secondly**, the establishment of EMU was a protracted and difficult process – it has involved a great deal of political and economic commitment. And **thirdly**, its gestation included a lengthy period of high inflation – which had consequences that many of those engaged in preparations for EMU were acutely aware of and determined not to repeat. At the same time there was a growing recognition that countries enjoying price stability were generally those who had given their central banks a strong measure of independence. This encouraged European politicians to agree to the creation of a fully independent central bank for Europe.

Turning to the objectives of monetary policy and the strategy employed to achieve them, how do the ECB and the Fed compare? The Fed's broad mandate is "to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates", while, under the Maastricht Treaty, the primary objective of the ESCB is to maintain price stability. But the Treaty **also** explicitly requires the ESCB, without prejudice to that objective, to support the general economic policies in the Community, which, as you would expect, include economic growth and employment. And here I should emphasise that the ECB's implementation of its mandate has been very supportive of growth; and it continues to be so, even after the increase, to 2¼%, agreed last week.

On strategy, like the Fed, the ECB does not have an inflation target. It defines price stability as inflation below or close to 2% over the medium term; uses economic analysis to identify short to medium-term risks to price stability; and employs monetary analysis as a cross-check vis-à-vis the medium to longer term. This approach recognises that price developments in the short to medium term are largely influenced by the interplay of supply and demand in these markets, while it is over the long term that money growth and inflation are closely related.

In the context of this strategy effective communication is critical. The approaches adopted by the Fed and the ECB differ in some respects. The ECB does not publish minutes, nor does it provide details of voting. However, immediately after each monthly monetary policy meeting, the ECB issues a detailed statement setting out its assessment; and the President holds a press conference, where the reasoning behind monetary policy decisions is fully explained. While there's a difference in style between the Fed and the ECB, the substance – what has happened and why – is not, I feel, so different.

Experience to Date

So, what has been our experience to date? Since the beginning of EMU, inflation and inflation expectations have remained firmly under control. That long-term inflation expectations have been well anchored is evident, not only from the surveys of private economists, but also in the inflation expectations embedded in bond prices. Indeed, a number of governments are issuing bonds on a 30 or even 50-year basis. This reflects the confidence that European and global investors have that the Governing Council will deliver into the very distant future, very low inflation in line with the definition of price stability. Undoubtedly this has been a key factor in permitting euro area interest rates to remain at their lowest levels in decades. For instance, ten year bond yields currently are below 3½%, as compared to around 8% in the early '90s.

Economic growth in the euro area has been somewhat disappointing. While annual growth has averaged almost 2% since the beginning of EMU, much of this was due to expansionary fiscal policies during the early years. In fact, over the past five years, growth has averaged less than 1.4%. During this period monetary policy has been very supportive of growth, with long bond yields averaging 4.2%; real yields have been about 2% and real short-term rates have been little in excess of 50 basis points. Undoubtedly, cyclical factors have played a role in depressing growth; but it is generally accepted that low growth has been due in the main to structural factors and that the answer lies in structural reform.

I think it's also important in this context to look at the effect of EMU on businessmen and consumers. Both have benefited considerably. A key outcome for businessmen has been the almost complete convergence of long-term interest rates to the **lowest**, rather than the **average**, level in the euro area, which has improved the cost of financing materially in many parts of the region. Exchange rate volatility is now a thing of the past, as are exchange rate trading margins and commissions. The substantial rise in the proportion of euro area trade invoiced or settlement in euro could be indicative – I would go no further than that – of increasing benefits to exporters and importers from the gradually growing international role of the euro. For consumers too, the benefits have been considerable, particularly since the introduction of euro notes and coin. The greater transparency that we were promised has indeed materialised and may well be operating as a welcome factor in promoting greater competition. The convenience of being able to use the same currency from Portugal to Finland is, perhaps, most keenly felt when one has to change euro into foreign currency when travelling outside the euro area.

I should add in passing that the almost instantaneous establishment of a single euro area money market at the start of EMU was greatly assisted by the European Union's large value payment system. This system is somewhat akin to your Fedwire. This system, known as TARGET, is a mechanism to effect wholesale cross-border payments in euro in real time on a gross settlement basis. It links over 50,000 banks across the EU and it processes and transmits each day over a quarter of a million payments, with a total value of €1.7 trillion (around $2 trillion). For the consumer, cross-border retail payments remain difficult, because of technical differences in retail banking systems across the euro area. But plans are afoot, by the end of this decade, to make it possible for a retail customer to make a payment from Paris to Dublin as easily and at the same cost as he can do in my own country, say from Dublin to Cork.

The adoption of the euro has also provided a new impetus for the development and integration of financial markets in Europe; it encourages a better allocation of capital by reducing the risks and costs of cross-border financial activity. The EU Commission's Financial Services Action Plan (FSAP) provides the necessary legal framework and institutional measures have been introduced to make the process operational. The need now is to ensure the effective implementation – in a consistent way across the EU – of the large body of legislation emanating from the action plan; and to do this in a context where cultural, structural and legal barriers to financial integration remain.

Finally, concluding this review of developments to date, it is important to note that the backdrop to these developments has been quite testing. The first eighteen months of EMU witnessed a large increase in oil prices, the collapse of the dot com boom and a significant fall in the value of the euro – subsequently reversed and the euro is now back to its launch level. Efforts to correct the sizeable imbalances generated by the late 1990s boom, allied to heightened geopolitical tensions, then triggered the most critical and sustained period of economic and financial uncertainty witnessed in decades. This uncertainty then unwound considerably, but it has returned more recently, mainly on the back of the sharp rise in oil prices and the further deterioration of the global imbalances. The new currency has, I'm sure you will agree, been faced with the significant challenges, but it has responded to them well.

Recent Interest Rate Change

Before I go on, let me comment briefly on last week's decision to increase interest rates. That decision was taken against the background of the risks to price stability that have been identified; it will help to keep medium to long-term inflation anchored at levels consistent with price stability; and will leave interest rates at a level that continues to lend considerable support to economic growth. The Governing Council has not taken any “ex ante” decision to engage in a series of interest rate increases; its mandate is to maintain price stability and it will continue to monitor all developments closely and will take the decisions it deems appropriate to deliver price stability.

Future Challenges

I will now focus on the main challenges that the euro area must address in the years ahead.

Growth

Clearly the major challenge is that of low actual and potential economic growth. But before I approach that issue, I would like to offer some comments on growth and inflation differentials between the countries that go to make up the euro area.

Since the signing of the Maastricht Treaty in 1991 question marks have been raised, from time to time, about the suitability of the euro area as an “optimal currency area”; one of the key aspects of the latter is that business cycles among the members of such an area should be highly correlated. Given the current situation in the euro area, where growth in some of the larger economies is quite depressed, while other countries – like my own – continue to do well, it’s perhaps unsurprising that this issue should attract attention. But the facts are that, far from increasing in recent years, growth differentials have actually moderated since the start of EMU, while inflation differentials have also remained low.

Looking at the figures in more detail, annual average dispersion of real GDP growth rates among the region’s twelve economies – calculated using a simple unweighted standard deviation – has declined by a full percentage point since 1999 (from 2.5 to 1.5%). Currently dispersion is only marginally higher than that experienced in similar areas, most notably the United States. Here, cultural differences, affecting labour mobility, could be a factor – but one which, if Ireland’s experience is anything to go on, can be expected to become less important.

Developments in consumer prices add further weight to this view. Euro area inflation differentials declined sharply over the course of the 1990’s, against the backdrop of strict convergence criteria for participation in EMU, which included the requirement that a country's inflation rate be within one and a half per cent of the average of the three lowest inflation rates in the region. This resulted in the dispersion of annual inflation rates – again measured in the same way – declining from over five per cent in 1990 to just one per cent by 1999. Since then it has stayed at that level, which is broadly in line with that experienced across the fourteen US metropolitan statistical areas in recent years.

In short, the evidence does not support the view that the current members of the euro area are unsuited to a common currency. On the contrary, growth and inflation differentials are close to the levels seen here in the United States.

Need for Reform

This brings me to the issue of low growth and the need for structural reform. Where the euro area differs significantly from the U.S. is in terms of productivity and employment growth. In the fifteen years to the mid-nineties productivity growth in the euro area was considerably better than in the U.S.; but the position was reversed in the years that followed and, over the past four years, annual productivity growth in the U.S., at close on 3%, is about three times that in the euro area. Currently hourly output per head in the euro area is about 8% less than in the U.S; but there are relatively fewer at work and the number of hours that they work is also less; the upshot is that GDP per capita in the euro area is only 70% of that in the U.S.

So what is Europe doing about it? Well, to paraphrase what is known as the 'Lisbon Agenda', Europe has committed itself, by the end of this decade to becoming a vibrant source of economic growth in a context of accelerating globalisation and rapid technological change. Not that we in Europe believe, any more than you do in the US, that governments can create long term growth. But what they can do is to **remove** rigidities in goods, services and labour markets and **introduce** policies that foster development and innovation.

To this end our first basic aim is to create more jobs – by amending unemployment schemes and providing incentives for people to work longer. Boosting labour productivity is a central plank of the strategy to increase potential growth. Three elements are seen to be key to this process – research and development, education and well functioning markets. For **research and development** the aim is for spending to reach 3% of GDP, two-thirds of this privately funded, in order to enable Europe to generate and exploit new knowledge and ideas and to benefit fully from the innovation and technical diffusion that globalisation facilitates. As regards **education and training**, for a knowledge-based economy to flourish in the euro area a highly educated work force is needed, but only in Ireland and Finland is the proportion of graduates comparable to that in the U.S. For us in Ireland the rapid development of ICT industries, largely stemming from US FDI, had a major role to play in the development of our human capital. And creating **well functioning, competitive and efficient markets** is another central aspect of the strategy to increase productivity. Here, progress has been made in a number of network industries, notably the telecommunications, air transport and some energy markets, which are now fully or largely open to competition.

Overall, progress is being made in many areas. But, in a region where growth is low and unemployment stubbornly high, no one underestimates the task that faces us. What needs to be done is clear, at both the Union and Member States level; mobilising the necessary will is, as always, more challenging.

One area of reform that has received much attention over the past couple of years, has been the review of the fiscal framework – the Stability and Growth Pact – or, in short, the Pact. The Pact has not lacked critics in recent years, but there are, I believe, good reasons for its continued existence. **First**, the Pact is a necessary part of EMU. In the absence of a federal tax system such as the one you have here in the United States, where resources can readily be transferred between states and regions, the EU's instrument to co-ordinate fiscal policy is the Pact. In a monetary union, the incentive for individual countries to pursue sound fiscal policies can be eroded by their ability to free-ride on others, hence, the need for 'housekeeping rules'. If you look at the continuing low differentials in yields across the euro area, you will appreciate what I mean. **Secondly**, fiscal discipline is important for maintaining price stability. Given the 'deficit bias' in public finances – it is always much easier to loosen fiscal policy than to tighten it – some kind of fiscal rule can be useful in maintaining budgetary discipline. For instance, for over a decade we in Ireland have reaped the rewards of prudent fiscal management. **Thirdly**, I have no doubt but that fiscal outcomes would have been considerably worse without the Pact; despite recent slippages, the deficit for the euro area as a whole is still little over half of what it was a decade ago. **Finally**, looking to the future – and this is something that will also be relevant in the US in years to come – the Pact helps Member States to prepare for the enormous challenge of ageing populations.

The recent reform of the Pact set out to address many of the criticisms levelled against it. In particular, it takes greater account of economic cycles, which permits automatic stabilisers to operate more freely; greater provision is made for investment; and deadlines for correcting excessive deficits can be extended under certain conditions. The challenge now is to enable fiscal policies to make their best contribution to stability and growth, through rigorous implementation of the revised Pact that will reinforce the credibility of structural reform plans and boost overall economic expectations. Against that background our view as central bankers is that the pace of fiscal consolidation remains too slow. In saying that, I am well aware that structural reforms can entail short run fiscal costs and that fiscal adjustment needs to take place in a way that does not stifle economic recovery. But experience also suggests that bold, well signalled, programmes of fiscal adjustment can help to create the kind of confidence that is currently lacking, particularly among consumers, and to generate the capacity for self-sustained growth that Europe requires in the years ahead.

Enlargement

Enlargement of the euro area will also pose a challenge. As you are aware, on 1 May 2004 ten new Member States, mostly from Central and Eastern Europe, became members of the European Union. All of these countries will ultimately adopt the euro, on fulfilment of the convergence criteria laid down in the Treaty. One of these criteria relates to participation – without severe tensions for a period of at least two years – in the Exchange Rate Mechanism (ERM II), which is also designed to help them in orienting their policies to stability and fostering convergence. All bar three of the new Member States have joined ERM II and virtually all have expressed a desire to join the euro area over the next few years.

Enlargement of the euro area to include all ten countries would raise the population of the area by over a fifth, to 375 million people. In economic terms the impact is much smaller, with GDP rising by just 7%; while GDP per capita varies widely between these countries, on average it amounts to only half that of the euro area. Over the foreseeable future living standards in these countries can be expected to converge to those of the euro area, underpinned by low costs and strong productivity gains from adopting technologies already prevalent in advanced economies. This process is already well underway, with these countries enjoying consistently higher economic growth than in the euro area; and strong inflows of foreign investment have helped to boost output, productivity and wages. However, inflation risks are also much higher than in the euro area, with wage growth in sectors where productivity growth is strong driving wages for the whole economy and asset prices also increasing rapidly. Managing this real convergence process is likely to pose challenges for these countries and, perhaps to a lesser extent, for the euro area itself.

However, one shouldn't overstate this: the countries concerned have shown considerable skill in addressing economic problems and, as I pointed out, the euro area has already operated well in a testing environment. And I would contend that the benefits from its enlargement – exchange rate stability and low interest rates for the new Member States and greater economic and political cohesion for Europe as a whole – are well worth working for.

This view is well borne out by my own country's experience of EMU. Ireland's decision to participate in EMU further enhanced the attractiveness of the economy as a location for foreign direct investment. Falling interest rates during the 1990s, in anticipation of EMU, supported domestic demand and enabled the economy to fulfil its strong growth potential. And, indeed, the lower and more certain interest rate environment continues to have a positive economic impact on investment and growth. Membership of EMU has also opened up new markets and reduced currency transaction costs for Irish exporters, while consumers have benefited from greater competition in product and financial markets.

Concluding Remarks

EMU is a venture of unparalleled scale and complexity. In logistical terms alone, it involved the simultaneous launch in January 2002 in twelve countries of 8 billion banknotes and 39 billion coins. Against a background of a series of global shocks EMU has successfully delivered low inflation and inflation expectations; historically low short and long-term interest rates for all Member States; and the removal of exchange risk for the bulk of their external trade. Undoubtedly, challenges lie ahead, not least in securing fiscal adjustment in a difficult economic environment in some euro area countries and gradually transforming the euro area into a region that continues to enjoy macroeconomic stability, but at a considerably higher level of economic activity. These are real challenges and will call for much economic skill and political will. But experience suggests that EMU is well equipped to meet them.