Christian Noyer: The euro area: a collection of countries or a single economic entity?

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the American Chamber of Commerce in Germany, Stuttgart, 29 June 2001.

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Ladies and gentlemen, it is a great pleasure to be at the American Chamber of Commerce in Stuttgart.

The question posed in the title of this speech can be addressed by noting that the euro area comprises those – currently twelve – Member States of the European Union which have adopted the euro as their single currency and thereby irrevocably transferred the responsibility for conducting monetary policy from the national level to a supra-national and independent institution, the European Central Bank (ECB). Consequently, as regards monetary policy, the euro area is, by construction, a single entity. This is also the case for many other fields of economic interaction. Most important is the Single Market, which ensures freedom of movement of persons and free trade in goods, services and capital across the whole European Union and therefore also in the euro area. The single currency completes the Single Market. The euro area is thus, to a very large extent, a single economic entity.

Obviously, this answer does not imply that the euro area is also a single political entity. However, and most importantly, what is crucial is not whether the euro area is a single entity in each respect. From an economic point of view, the relevant question is whether the political and institutional framework which governs the euro area is designed in such a way as to ensure bright long-term prospects for the euro area in terms of employment, real growth and, more generally, living standards of its citizens? In this respect, while I see an urgent need for further structural reforms in the euro area, let me emphasise at the outset that I am rather optimistic as concerns the long-term growth and employment prospects of the euro area. Not least as the euro, together with healthy competition among differing policy designs of national authorities, will act as a catalyst for further reform and integration.

In my presentation today, I will first briefly address the political and institutional structure underlying the euro area. Secondly, I will discuss some features of the ECB, the institution responsible for an area in which full integration has been achieved, namely monetary policy. Thirdly, I will discuss some of the challenges which need to be addressed to fully grasp the opportunities offered by the single currency, thereby further improving the economic prospects of the euro area. Finally, I shall argue that the unique institutional choice for the euro area brings many advantages and opportunities and thus, if properly handled and carefully further developed, is a very solid fundament for a substantially more dynamic long-term development of the euro area than most observers currently appear to expect.

Having the honour of speaking at the American Chamber of Commerce, I will – you will not be surprised – draw some comparisons with the United States of America.

The first is that the euro area is an economically integrated and large economic block that, in many respects, is similar to the US. These two economies are the two largest economic areas in the world. In 1999, the euro area GDP (including Greece) was equivalent to 16% of world GDP, whereas the share of the United States was 22%. In terms of population, the United States (with 272 million inhabitants) is slightly smaller than the euro area (with 302 million inhabitants).

Underlying institutional and political structures

The euro is both a product and part of the process of European integration, which began already fifty years ago. This is a process that continues to evolve.

The Eurosystem, comprising the ECB and the national central banks of the euro area, operates within the broader underlying framework of the European Union. In order to put this framework into perspective, allow me to draw a few simple comparisons with the US. Beginning with the similarities, I should first point out that both the EU and the US benefit from having written constitutions or constitution-like treaties. For the US, this is the constitution issued by the Philadelphia convention of 1787, while the EU's "constitution" is set out by the successive treaties which established first the European Community and later the European Union. Both the US constitution and the EU Treaty were entered into voluntarily and resulted in the closer union of the participating states. Both serve to lay down the level at which powers are to be exercised and decisions taken.

We must understand that the EU's underlying framework, like that of the US, is a product of its times. When the US constitution was drafted, the involvement of the state in economic matters was extremely limited. In fact it was not until over a century later that the US finally had a fully-fledged central bank, after earlier attempts to establish a national bank had ended in the Fed's predecessors being dissolved. By contrast, the process of European integration began at a time when the power of the state in managing and intervening in the economy was high and many thought that this power should indeed be used to a large extent.

Let me point out that since the establishment of the European Community, economic integration has served not only as an end in itself, but also as a means of achieving wider objectives, including greater political integration. Progress towards establishing the so-called "four freedoms", namely the free movement of goods, services, capital and labour, required, from the start, the creation of an institutional system with state-like attributes such as a legislative, an executive capacity and judiciary functions. As economic integration has progressed, this institutional system has developed and adapted. For instance, what was first a European Assembly with only consultative powers has now become a European Parliament with legislative responsibilities extended to more and more areas, and members of parliament who are directly elected by European citizens. Within the Council of Ministers, majority voting has increasingly become the norm at the expense of unanimity.

Finally, in addition to institutional reform, economic integration has also served to foster progress in areas beyond the economic sphere. In order to effectively guarantee the four freedoms, it has, for example, been deemed necessary to grant powers to the EU in fields such as immigration and human rights.

Ladies and gentlemen, as a consequence of the integration process that began largely in the economic sphere, the EU already exhibits a number of features of existing political unions in terms of both its institutional structure and its competencies. However, it is clearly not a complete political union. The extent to which further integration is either desirable or necessary is an ongoing debate. It is a debate that is ultimately for politicians, not for central bankers. Nevertheless, the process of European integration will undoubtedly also have implications for the conduct of the single monetary policy. No central bank operates in a vacuum. It needs to be supported by an appropriate underlying framework. There is no doubt that the overall performance of the euro area economy depends not just on economic, but also on institutional and political structures.

The European Central Bank

In this respect, judging by past experience, I am confident that if and when institutional or political changes do become necessary, the EU is and will be able to rise to this challenge. The introduction of the euro and the creation of a new institution, the ECB, which is responsible for the single monetary policy, provide clear evidence that this is already the case. Let me briefly discuss some features of the ECB, which has a clear mandate to focus on maintaining price stability in the euro area as a whole. In fact, in the euro area, monetary policy cannot be tailored to the specific needs of a country or region.

The single monetary policy is governed by the decision-making bodies of the ECB. These are the Governing Council and the Executive Board. They may be considered broadly comparable with the Federal Open Market Committee (FOMC) and the Board of Governors of the Federal Reserve System.

Like the FOMC, the Governing Council of the ECB is responsible for taking key monetary policy decisions, including the setting of official interest rates. Whereas the FOMC is composed of the members of the Board of Governors of the Federal Reserve System and four Reserve Bank presidents, the Governing Council is composed of the members of the Executive Board of the ECB and the Governors of the national central banks of the euro area. The Governors naturally bring with them their own country-specific expertise and experience. However, they are members of the Governing Council in a personal capacity and not as representatives of their countries or institutions. Their duty is to act in the interest of the euro area as a whole and, judging from my experience, this is indeed what they are doing.

The Executive Board of the ECB consists of the President, the Vice-President and four other members. It is responsible for preparing meetings of the Governing Council. It manages the day-to-day activities of the ECB and implements the monetary policy set by the Governing Council. In order to carry out this latter task, the Executive Board gives the necessary instructions to the national central banks.

To recapitulate, the Governing Council sets policy, the Executive Board implements policy; the related policy operations are then carried out by the national central banks in a harmonised manner. The role played by the national central banks in the implementation of monetary policy operations represents a difference in organisation between the Eurosystem and the Fed. While the Fed operates primarily through the Federal Reserve Bank of New York, the Eurosystem's monetary policy operations are carried out in a decentralised manner by each of the national central banks. This reflects possibly the differences in the operational framework. The ECB policy relies a great deal on the functioning of the money market and does not pursue daily interventions in the money market. Typically the ECB conducts only one weekly operation. In addition, it is useful for the ECB to draw on the experience of all central banks in Europe and their long-standing close contacts with the market participants.

In short, the Eurosystem is organised in a way that ensures the efficient formulation and implementation of a single and coherent monetary policy for the euro area as a whole. At the same time, it draws, to the extent appropriate, on the existing resources and expertise of the national central banks.

Structural reform needs in the euro area: improving market integration and competition

Ladies and gentlemen, let me now address economic areas where structural reforms are needed to further enhance the functioning and the economic prospects of the euro area. I should like to start by referring to one of the most important structural differences between the euro area and the US. Regarding the degree of regulation, the US is currently more flexible than the euro area. For instance, higher rates of turnover in the US labour market are a signal that employers enjoy greater flexibility in tailoring their staff numbers to production needs. Flexibility of factors of production, including labour, facilitates the introduction of new technologies, allowing firms to organise their production processes more efficiently and to improve their competitiveness. Moreover, flexibility lowers the adjustment costs associated with economic shocks.

The greater market flexibility in the US is connected with a relatively low degree of labour and goods market regulation as compared with the euro area. While important reforms have been introduced in a number of euro area countries, all in all there is still a long way to go in this respect. This emerges quite clearly from a comparison of the costs and procedures associated with the creation of new businesses, to mention just one example.

There is a wide diversity in regulatory arrangements across countries and sectors in the euro area. This diversity emerges quite clearly when looking at product markets. Whereas the integration of goods markets is relatively advanced, major shortcomings exist with regard to the full integration of service industries. Most of the barriers to trade in services appear to be due to national regulations, for example administrative procedures for setting up subsidiaries in other euro area countries. Regulatory barriers along these lines reduce competition in services, thus keeping the respective prices above the level that would be expected in a fully integrated market.

Much of the recent discussion on structural reforms in product markets has focused on regulatory reform in network industries, in particular telecommunications, electricity and gas. Following a number of important reforms in the 1990s, market opening in the telecommunications market has made considerable progress, while reforms in other network industries have generally remained more limited. The initiatives in the telecommunications sector show how reforms that succeed in increasing competition in previously sheltered sectors, considerably enhance productivity, lower relative prices and lead to new and better products, thereby increasing consumer welfare and job opportunities.

Turning now to labour markets, also here progress has been rather uneven across areas. A number of countries have lowered marginal tax rates in order to make their tax systems more employment friendly. Some progress has generally also been made with the introduction of more flexibility in working contracts and practices. In many other areas, however, important reforms have not yet got off the ground. For instance, few changes have been made regarding employment protection policies in euro area countries, which remain among the strictest in the industrial countries. Also, reforms aiming to simplify and limit unemployment benefit systems and thereby enhance employment growth have only slowly progressed in almost all euro area countries. The emergence of skill shortages and tight labour markets in several euro area countries shows that structural problems still remain and need to be solved. The euro area could use its potential much better, as is illustrated by its relatively low labour force participation. Whereas, in the euro area, the labour force participation rate was 67% in 1999, it amounted to 77% in the US.

All in all, we see that some traditional hurdles to market flexibility and competition are slowly being removed, but as regards the current state of affairs in the euro area there is certainly still plenty of scope and urgent need for improvement. Structural reforms are of paramount importance not only for raising the growth potential of the economy but, most importantly, for increasing employment prospects in the euro area.

Reasons to be optimistic regarding the long-term prospects of the euro area

Let me now explain why I am rather optimistic regarding the future development of the euro area economy. The euro area is already highly integrated in economic terms owing to the creation of the single currency and Single Market and further progress in this respect is ongoing. This is a good starting point for dynamic economic development.

My optimism is grounded in particular on the transformation we have witnessed over the past years, following the remarkable decision in favour of the Single Market. The successful establishment of the euro and the ECB, which together with the Single Market, have created a new economic entity, is evidence of the ability of Europe to implement far-reaching reforms which are well-designed and underpinned by solid institutional structures. This creation of an entirely new economic entity is a substantial step forward. The euro will act as a catalyst for further reform in many areas.

My optimism is further underpinned by the fact that the Treaty sets out a durable anchor to guide economic decisions and to reduce economic uncertainty substantially by entrusting an independent institution, the ECB, with a clear mandate of maintaining price stability. Moreover, the Treaty defines a clear and efficient allocation of responsibilities, where the single monetary policy is primarily responsible for price stability, while structural and fiscal policies at the national level are responsible for providing the necessary framework for enhancing potential growth and employment in a lasting manner, objectives for which governments, not central banks, have the appropriate instruments. This clear allocation of responsibilities ensures transparency and accountability, further fostering good policies. I do not think that a fully-fledged political union would necessarily guarantee better economic prospects.

In this respect, it is interesting to note that national governments will increasingly be scrutinised, both by the electorate and the capital markets, with comparisons being drawn between the economic performance of the various countries within the euro area. Also here, it is the single currency which enhances transparency and thus leads to improved competition with positive effects for all citizens. With a single monetary policy, striking cross-country deviations in real growth and unemployment can no longer be blamed on differences in monetary or exchange rate policies. Over time it will become increasingly clear that cross-country differences in economic performance are, to a considerable extent, related to national fiscal and structural policies. This will increase the incentives for carrying out structural reforms.

The general comparison between the euro area and the US presented above, obviously, does not do justice to the diversity that exists within the euro area. As the responsibility for structural reforms in the EU and in the euro area rests with the individual Member States, a wide variety of institutional solutions and regulatory arrangements across countries and sectors exist. In many areas I consider this decentralised approach to be an opportunity, not a disadvantage. It makes possible healthy competition between differing policy designs of national authorities and enables solutions that are tailored to the particular needs of a country or region. This fact, which is a clear advantage of the euro area economy compared with other more centralised economies, is often not recognised enough. Decentralised policies offer a unique opportunity to explore different solutions in a competitive manner, allowing the testing of various approaches and, if thought useful, selection of best practices with a high degree of confidence.

Fiscal policy is a good example of a field where Europe found an efficient solution in the form of common rules which keep the advantages of decentralisation and subsidiarity. As is well-known, budgetary policies remain under national responsibility, but effective common rules have been developed in the form of the excessive deficit procedure and the Stability and Growth Pact. These rules are designed to ensure that a high degree of fiscal discipline supports the single monetary policy in its primary objective of maintaining price stability. Thus, while the euro area shows a unique institutional setting – in contrast to monetary policy, fiscal policy is far from being single – national governments have agreed to common rules which ensure that the euro area remains an efficient and stability-oriented single economic area.

Conclusion

Let me conclude by saying that the single currency and the establishment of a new European institution responsible for monetary policy in the euro area complemented the process of economic integration that started half a century ago in Europe. This process and the institutional build-up, together with clear and coherent policy goals and an efficient allocation of the respective responsibilities, are transforming the euro area into an increasingly unified economic entity which, in many respects, resembles the US. Although most of the required structural reforms still have to be implemented, it cannot be denied that substantial progress has been made.

The introduction of the euro has been and will continue to be a powerful catalyst, contributing to greater competition in the economic and the political sphere, thereby further enhancing the welfare of the citizens in the euro area.

Ladies and gentlemen, political leaders throughout Europe have recognised the need for structural changes in both taxation and expenditure policies and regarding the deregulation of product and labour markets.

In this context, let me point out that the Lisbon European Council in March 2000 emphasised the need for economic reform, whose implementation is a key condition for the EU to achieve its strategic goal "to become the most competitive and dynamic knowledge-based economy in the world". The follow-up to the Lisbon strategy is ensured by an annual spring European Council meeting, the first of which took place in Stockholm earlier this year. These follow-up initiatives are also reflected in the recommendations of the Broad Economic Policy Guidelines.

It is sometimes argued that the euro area can only become a very strong and dynamic economic entity if supported by a fully-fledged political union. I have argued today that there are good reasons that this may not be true. The current policy constitution in the euro area, despite its novelty and uniqueness, is a sound and efficient framework which provides a good basis to ensure that, even without full political union, the euro area can become one of the most dynamic economic areas in the world.