EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Impact of the introduction of the euro on the economy. Future challenges, in particular coping with an ageing population.

INTERVENTION BY MR KLAUS REGLING

Director General, DG Economic and Financial Affairs, European Commission

International Monetary Symposium

Tokyo, 12 November 2004

Slide 2

It is a pleasure to participate in this conference. And it is an honour to take the floor after Governor Fukui and Vice-President Papademos. Since they have told you all you wanted to know about monetary developments, I will focus my contribution on two other issues: the economic consequences of our almost six years old Economic and Monetary Union and the future economic challenges. The two elements are quite closely related. In fact, the specific institutional set-up of the Economic and Monetary Union, or EMU, has implications for the conduct of economic policy, for the very functioning of our economies, and therefore, for the way we deal with current and future challenges.

Mr. Papademos told you about monetary policy. Ensuring price stability for the euro area as a whole is the responsibility of the ECB. By contrast, fiscal policy and structural policies remain under the responsibility of Member States, but they are subject to rules and coordination at the European level.

This specific setup has been chosen for several reasons:

- Firstly, with a single monetary policy and in the absence of the exchange rate as an adjustment mechanism, Member States need the possibility to react to economic shocks through a change in the fiscal policy stance.

- Secondly, excessive fiscal deficits should be avoided because they can have negative effects on the other members of the euro area.

Therefore, common rules, such as the Stability and Growth Pact, and coordination, mainly through the so-called Broad Economic Policy Guidelines, ensure that the euro area as a whole does not have to bear the cost of one member's fiscal slippage.

- Thirdly, structural policies are also of common concern. They should therefore be coordinated, because increased flexibility of product and labour markets can compensate for the absence of the exchange rate as an adjustment tool and also because they can raise the potential growth rate.

Some analysts have questioned, from the outset, this assignment of policy responsibilities. In particular, some doubted the viability of a monetary union without a full political union. I will argue that they have been too pessimistic. Nevertheless, practice has shown that the coordination of national and common policies is a difficult task, and major challenges in that field remain.

Let me now summarize the ***economic developments in the early years of EMU***

Slide 3

With its emphasis on price stability and sound public finances, EMU has provided the kind of stable macroeconomic policy environment that was lacking in many European countries. The run-up to the launch of the euro saw significant reductions in inflation [from average rates above 4 per cent in the early 1990s, and more than 10 per cent in some countries, to 1.5 per cent in 1998]. The state of public finances has also improved considerably (deficits fell from more than 5 % on average, and close to 10 % of GDP in some countries, in the early 90s to less than 3% during the last few years).

In addition, there is clear evidence that EMU has boosted trade among its members. The abolition of exchange rate risk and the enhanced transparency that came from pricing goods and services in a single currency have clearly encouraged more cross-border activity. Moreover, the attractiveness of the euro area as a destination for foreign investment has increased significantly since euro area members have attracted an increasing share of total FDI inflows into the EU.

Slide 4

The euro-area’s growth performance since 1999 has, on the other hand, been mixed. Economic activity was unexpectedly buoyant in 1999 and 2000, with real GDP growth peaking at 3.5 per cent in 2000 – the highest level for a decade.

But the cyclical upswing did not last long. The euro area was hit hard by the slowdown in the global economy that set in from 2001 onwards. The turnaround finally occurred in the summer of 2003, and a recovery is now under way. The Commission expects growth to be around 2.1% this year and 2% in 2005.

The recovery is still to a large extent driven by net exports. This dependency on an external motor entails risks: In 2002, the quick recovery of the euro area stalled as soon as world import demand weakened.

This is why it is important to make progress on the structural front so as to be able to rely on domestic demand. The functioning of labour and product markets has improved in Europe – more than is often recognized. The liberalisation of network industries such as telecommunication has resulted in price reductions that were sometimes dramatic. Our research (Annual Review 2002) suggests that competition policies and regulatory reform have contributed to a reduction of price mark-ups by companies, thereby benefiting the consumer and improving the efficiency of the economy.

But let me stress that the most positive development has been in the area of labour utilisation. 15 million new jobs have been created in the euro area since the mid-1990s. The employment rate increased from 60.3% in 1999 to 62.5% in 2003. Moreover, employment appears now to be more resilient to slowdowns. Previously, every downturn in Europe resulted in a ratcheting up of the unemployment rate. This did not happen during the latest slowdown. In my view, this shows that the reforms largely enacted before the start of EMU have led to a clear reduction in the level of structural unemployment in the euro area.

Slide 5

However, labour productivity remains a concern. Labour productivity growth has decelerated from 1.7 per cent in the first half of the 1990s to only 0.7 per cent in the past five years.

KEY POLICY CHALLENGES

Given economic developments in recent years, what are our main policy challenges? I will first talk about fiscal policy where, in the light of the experience gained so far, some adjustments to the coordination framework might be called for. The economic consequences of demographic trends are the second challenge I will address. They make an even stronger case for a sound fiscal framework, but their implications concern the economy as a whole. I will therefore thirdly talk about the necessity of further structural reforms.

Fiscal policy

Slide 6

As you know, an impressive degree of fiscal consolidation was achieved in the run-up to the launch of the euro. Current budgetary trends also compare favourably with the past, when economic downturns were typically accompanied by a serious deterioration in budgetary positions.

It is true, however, that we have encountered serious problems in implementing the fiscal framework. In 2003, less than half[1] of all euro area Member States complied with the key objective of the Stability and Growth Pact: a budgetary position that is "close to balance or in surplus". In addition, we have witnessed considerable deviations from planned

[1] Four had deficits above 3% of GDP and another three between 1 and 3%. Their cyclically adjusted balances showed deficit of 0.9 to 3.9%.

consolidation paths, and at least three countries in the euro area will have deficits above 3% of GDP this year.

These problems are partly due to the weak economic conditions but also reflect to some extent a lack of political will to implement commonly agreed targets and frameworks. Given more than five years of experience and in anticipation of 10 new EU member states that will join EMU in the future, the Commission has developed some ideas for improving the fiscal framework. The gist of these proposals can be summarised as follows:

First, budgetary developments should be seen in relation to the business cycle, long-term sustainability and structural policies to enhance the growth potential. Our ageing societies require a stronger attention to longer-term fiscal sustainability.

Second, the medium-term budgetary objective of the Stability and Growth Pact should take into account country-specific circumstances and look at the overall sustainability of public finances, while ensuring that public deficits remain below 3% of GDP. In practice, some countries with high debt levels may have to aim for a permanent surplus, while others with low debt, and higher potential growth, could be allowed to run small deficits in cyclically normal times.

Third, there should be more focus on government debt and fiscal sustainability, but not at the expense of the deficit criterion. The 3% deficit ceiling will remain the anchor of the system.

Finally, ensuring that countries take early action to correct excessive deficits is crucial, which requires strengthened procedures for enforcing this correction of excessive deficits.

These proposals are now being discussed with our member states and we are aiming for reaching a consensus during the first half of next year.

Ageing

The key challenge we face over the next few decades is ageing. This is a challenge Europe shares with many Asian countries, including Japan. In coming decades, both the size and age structure of Europe’s population will undergo dramatic changes due to the current low fertility rates [1.5 per woman, whereas the replacement rate is 2.1] and increasing life expectancy.

Slide 7

The working-age population (i.e. aged between 15 and 64) is projected to decline very significantly in the enlarged EU starting in 2010 from 309 million to 251 million in 2050, a drop of 50 million persons or 18%. The population of older persons aged 65 and above will double from some 60 million today to 121 in 2050. The ratio of persons of retirement age (65+) to those of working age (15-64), the so-called old-age dependency ratio, will dramatically change: it is projected to double from some 25 % today to over 50% in 2050. In other words, the EU would move from a situation today of having 4 working-age citizens for every elderly one to a ratio of 2 to 1.

Could inward migration somewhat offset this trend, thereby offering a solution? In principle, migration could partially compensate the effects of low fertility rates and increasing life expectancy. However, migration control remains high on the political agenda of many countries already at the current levels of foreign population – some 4½ per cent of the population in the EU and less that 1½ per cent in Japan is foreign. Unless policy and public opinion radically change in favour of much bigger inward migration, it is most unlikely that the overall trend towards an ageing population will be altered significantly through more migration.

Obviously, ageing populations have a significant impact on the whole economy. Changes in living standards over time are largely dictated by underlying productivity and employment rate developments. Over the past forty years, we have become accustomed to increasing levels of prosperity as a result of sustained increases in labour supply and high levels of productivity growth. However, population ageing means that these sources of growth cannot be taken for granted in the future.

Slide 8

Since the working-age population in Europe will start to shrink, productivity growth needs to increase in order to avoid a fall in the potential growth rate. Our analysis shows that, as a "pure" result of ageing populations, potential growth in the EU-15 would be reduced from the present rate of 2-2¼% to about 1¼% by 2040. The negative impact on economic growth could be even more severe in Japan, whereas in contrast, potential growth rates are projected to remain robust at about 2½% in the US.

Slide 9

Growth developments along these lines will have a profound impact on global output distribution. The EU-15 would see its share in world output fall from 18% today to 10% in 2050, and the share of Japan would halve from 8% to 4% over the same period. In contrast, the US is projected to continue to increase its share of global output to some 26% by 2050.

Slide 10

Demographic changes also entail significant budgetary risks. Around two thirds of public expenditures are directly affected by demographic changes. Our projections indicate that population ageing will lead to an increase in public spending of between 3 and 7 percentage points of GDP in most Member States in coming decades with increased spending on pensions, health care and long-term care.

There are also some additional implications in a monetary union, since an unsustainable public finance position of a few members could complicate the implementation of the single monetary policy and possibly result in higher interest rates. This is why the Commission has tabled, as I mentioned, a proposal to strengthen the SGP framework.

Structural reforms

The other major element of the EU reform strategy is structural. It aims at increasing productivity and the growth potential of our economies. The Lisbon European Council in 2000 diagnosed slow growth as the key long-term EU challenge. It decided on a strategy to inject dynamism into the economy and agreed ambitiously to raise the potential growth rate to 3% by 2010 through the implementation of structural reforms.

Slide 11

Some important progress has been achieved since then; not only in the area of employment, which I mentioned earlier, but also with product market reform and financial market integration. Regrettably, it turns out that the overall pace of implementation of reforms is yet insufficient. [Taking the example of the labour market, most progress has been made in relatively easy areas from a political point of view, such as active labour market policies, education and training measures and reductions in the tax burden on labour. Reform in politically more tricky areas has only just started.]

[As regards product market reforms, the integration process has raised the level of competition in European product markets. A key point of the current policy agenda is now to stimulate productivity growth. In this context, spending on Research and Development represents less than 2% of GDP in the EU compared to a bit more than 3% in Japan. The increase over the past years has been small, making it unlikely, at the current pace, that the 3% of GDP objective will be reached.]

Structural reforms tend to be mutually reinforcing. It is therefore crucial to implement reforms in all areas and in all Member States of the EU. This is the main priority of the incoming Commission.

CONCLUSIONS

Slide 12

Still, I would imagine that the performance of EMU so far has impressed its sceptics, of which there were many, especially in the economics profession. The single currency has reinforced macroeconomic stability and increased the integration of product, labour and financial markets in Europe.

But further progress is now needed in many areas. The fiscal framework needs to be strengthened. Population ageing requires both sounder fiscal policies and the bold implementation of structural reforms. We need to increase the growth potential of our economies by being more productive. By addressing those issues, I am confident that we will manage to meet the challenges with success.

Thank you for your attention.