The Economic Club of New York

The Euro, The European Union's Innovation Strategy and the EU's Enlargement

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Ladies and gentlemen,

It gives me great pleasure to speak to such a distinguished community of business and financial leaders.

Tonight I want to stick to economics. Not only because this subject is close to your hearts as well as mine, but also because, as some of you may know, I have been professor of industrial economics for 25 years -- before becoming Prime Minister of Italy and later President of the European Commission. So in a way, speaking about economics takes me back to my younger days.

Tonight I want to focus on three topics that have had and will have a great impact on the EU economy, on the future of transatlantic relations and on our professional lives too: the euro, the Union's strategy for innovation in the next decade and the Union's forthcoming enlargement to embrace 10 new countries.

The euro

A single currency has long been a dream for many Europeans -- a dream that started more than 50 years ago, at the end of a war that started in Europe, spread throughout the world and left our continent devastated.

Out of the follies of nationalism and protectionism that had led to war grew a new determination. Europe's leaders resolved to ensure economic and social progress in their countries by eliminating the barriers that divided the continent.

This determination to coordinate the efforts of the Member States to rebuild their economies and their societies -- helped *inter alia* by the Marshall Plan -- eventually led to the establishment of the European Community in 1958. The guiding idea was simple and powerful: "peace through prosperity".

Europeans strongly believed that prosperity could come through trade between Member States. But eliminating trade barriers was never regarded as sufficient to foster trade and create a true common market in Europe. Many always regarded exchange-rate stability as an important condition for trade expansion too.

Since 1944, exchange rates had remained fairly stable in Europe and elsewhere thanks to the Bretton Woods system. Together with the liberalisation of trade, this situation allowed trade to expand rapidly in Europe and elsewhere.

As long as the Bretton Woods system operated smoothly, there was relatively little need for monetary unification in Europe. But in the late 1960s, cracks started to appear in the Bretton

Woods system and the idea of monetary unification in Europe resurfaced.

In 1971, the Bretton Woods system broke down, and in 1978, EC governments agreed to establish a European Monetary System in order to create a "zone of monetary stability".

In fact, the European Monetary System was like a mini-Bretton Woods system. The French franc, the Italian lira and other European currencies in the system were fixed essentially in relation to the German mark, which floated against the US dollar, the yen and other world currencies.

The system worked remarkably well throughout most of the 1980s, in spite of major shocks to the European economy. However, as different national markets for goods, services, capital and labour started to integrate into a Single Market in 1986, the European Monetary System became unsustainable.

The fact was -- as many economists soon realised -- Europe could not have stable exchange rates, free capital movements and independent monetary policies all at once. With the close integration of European markets in goods and services and the full liberalisation of capital

movements, large exchange-rate fluctuations were simply not acceptable. So maintaining free capital movements called for a common monetary policy.

Put very simply, a stable European Single Market required a stable single European currency. And the roadmap to that Single European Currency -- the name "euro" was only decided on in December 1995 -- was set out in the Maastricht Treaty of 1992.

This roadmap was meant to guarantee price stability and sound public finances in all the EU countries adopting the euro. Since the Maastricht Treaty came into force, price stability improved steadily and has now reached record low levels of inflation and interest rates. Public finances have also improved dramatically and the "culture of fiscal stability" has become an intrinsic component of the EU economy.

On 1 January 1999, 11 EU countries permanently locked their bilateral exchange rates and the euro became the official currency of these countries. On 1 January 2002, the dream finally became reality and euro notes and coins were in the pockets of 300 million Europeans across 12 different EU countries.

In just a couple of years, the euro has established itself as the second-most-important currency after the US dollar on the world's financial markets.

Following the introduction of the euro, there was a huge surge in euro-denominated bond and note issues. At the end of 1998, the outstanding amount of bonds and notes denominated in the legacy currencies of the euro accounted for barely 28% of world issues, compared to 45% for dollar-denominated bonds and notes. By mid-2003, the gap had become relatively small: the share of issues in dollars had fallen to 43%, while the euro's share had increased to 41%.

An even more spectacular development took place on the money market. At the end of 1998, money-market instruments denominated in the euro's predecessor currencies accounted for just over 17% of world issues, compared to 58% for dollar-denominated instruments. By mid-2003,

the share of issues in dollars had fallen to 30%, while the share of euro issues had climbed to almost 46%.

Overall, therefore, euro-denominated debt issuance has increased enormously in a very short span of time.

The same confidence in the euro is also visible in the official sector, and the euro is already widely used as an anchor or reference currency in the exchange regimes of non-EU countries. Over 50 countries operate managed exchange-rate arrangements that include the euro as a reference, either in isolation or in conjunction with other reserve currencies.

The types of arrangements adopted by non-member countries range from currency boards to managed floats. These countries are located mainly in Europe and Africa. The main reason why these countries have adopted the euro as a reference currency is, obviously, their extensive trade and financial links with the euro area.

As a reserve currency, the euro accounted for almost 15% of official reserves in 2002. Admittedly it still played a much smaller role than the US dollar, whose share amounted to 65%. By holding large amounts of US dollars, the European Central Bank itself contributes to the prevailing role of the US currency as an official reserve currency.

To me it is rather clear that the sustained strength of the euro in the last 18 months is a reflection, among other things, of the trust and confidence that private and public operators put in the European currency.

Growth, economic reforms and the EU strategy for innovation

While Europe now has an enviable record of stability thanks to the euro, there are areas where the Union has not matched the success of the euro.

Growth is the main one. Europe cannot be satisfied with its own growth performance of past years and it must increase its potential growth in the years ahead.

Per-capita income convergence *vis-à-vis* the United States halted in 1970. Since then, the EU per-capita income level has stood at around 70% of that of the US. During the first half of the 1990s, restructuring led to heavy labour shedding and a strong increase in productivity in spite of low overall growth. During the rebound in the second half of the decade, the strong increase in employment came at the expense of increases in labour productivity.

Meanwhile, spurred by a successful transition to the knowledge-based economy, the US posted a higher growth rate in the 1990s than during the previous two decades. Labour supply in the US increased substantially both for demographic reasons and higher participation rates.

But US growth was also stimulated by a strong increase in labour productivity. For the first time in three decades, growth in US labour productivity outstripped that of the EU, an extraordinary performance for a country at the leading edge of the production possibility frontier.

I see the EU's low growth as a symptom of an economic malaise and a signal that structural reforms are needed. At their Spring Council in March 2000, the EU heads of State and government set a goal for Europe: that of improving competitiveness and economic dynamism by embracing knowledge and innovation and by ensuring environmental and social sustainability in the long run. This meant supporting the EU macro-economic framework with a coordinated strategy of micro-economic and social reforms and regular monitoring of their implementation.

The goal of this strategy of micro-economic and social reforms is to improve the way the markets -- all markets -- function, thus enhancing flexibility in the euro-area economy, and ultimately increasing its potential growth and reducing structural unemployment. After three years of disappointing growth, the EU economy is now showing signs of recovery. We trust these will be confirmed in 2004 and 2005, when the EU will hopefully be able to achieve its potential growth again.

Progress in structural reforms is among the main factors supporting this positive outlook. The Union's strategy for innovation, which is my second topic today, is a central plank of the strategy for structural reforms.

The EU innovation strategy encompasses a wide range of policy measures. I will focus first on the supply side of innovation -- knowledge creation -- and then on the demand side of innovation -- the marketability of innovative products.

Knowledge creation means investing in people first and foremost. Knowledge is the key to innovation. Europe currently invests less in R&D than the US. In 1999, total US expenditure on R&D was 2.6% of US GDP.

This was over a third higher than in the EU. In the US, the public sector contributed one fifth to the increase in R&D expenditure between 1996 and 2000. In the EU, public research budgets declined.

This is why the EU heads of State and government have set themselves the goal of raising EU investment in R&D to 3% of GDP by 2010, with two thirds coming from the private sector.

When it comes to generating new ideas and frontier research, there are benefits in concentrating such research. It would benefit us all if the many excellent scientists working in the Union were given the opportunity to conduct their research in European centers of excellence.

At present, the allocation of national public funding for science is still largely determined by national borders. We have to establish a genuine European Research Area. But we could do even more. We could consider a European Research Agency. The National Science Foundation in the US is a good example in this area.

The EU institutions can and should play their part in mobilizing available financial resources to foster growth and innovation. This can be done both via the EU central budget and via loans managed by the European Investment Bank (EIB).

Within the Commission, we have now started a debate on the future financial framework of the EU central budget. Our view is that the EU budget must better reflect the priorities -- such as investing more in R&D and education -- to which the EU heads of State and government have committed themselves.

Our view is also that the saving affluence and the top rating of EIB loans should be better exploited to ensure the financial viability of longer horizon investments. The EIB has indeed provided significant lending over the last few years to education and training activities.

But this is not yet enough. We must make sure that European companies are willing to seize the opportunities offered by a well-trained workforce. We must ensure that entrepreneurs are willing to transform the creativity of researchers into excellent investment opportunities -- that is, into innovative and marketable products.

In a word we must make sure that there is demand for innovation and that we give the market the right incentives to provide finance for innovation. Only then will productivity growth translate into employment growth.

Let me give you a few examples of our policies that concern the demand side of innovative ideas.

First, there is the maturing risk-capital industry in the Union. The gap with the US is still wide but closing. In the EU, venture-capital investment in the year 2002 amounted to 0.1 % of GDP, while it was double in the US at 0.2% of GDP. Three years before, however, the share of venture capital in GDP was four times higher in the US than in the EU.

Within the European Union, we can support risk-capital industry with some legislative measures. For example, the heads of State and government have called on the Commission to look into the obstacles preventing pension funds from investing in venture-capital markets.

Second, private equity investors are willing to provide more funds if they have good exit opportunities. As you know, European high-growth stock exchanges are smaller (and younger) than their US counterpart, but I hope that, after the reorganization of some European stock exchanges, publicly traded securities will become an accepted and trusted means of financing young companies in Europe.

Furthermore, the EU has modernized and unified its rules on prospectuses. This will facilitate the exit of risk capital. Approval from a single regulatory authority in a single Member State will now be sufficient to put securities on the EU-wide market. We call these initial disclosure requirements the "single passport for issuers".

Third, market allocation of funds to high-growth projects does not, of course, happen only via venture capital and IPOs (Initial Public Offerings). Properly functioning financial markets in general channel funds to their most productive use and are thus vital for our economic growth performance.

Overcoming the fragmentation of capital markets in Europe remains a priority for lowering the cost of capital to European companies. A recent study conducted for the European Commission calculated that, in the long run, an integrated European capital market could raise the level of GDP in the EU by 1.1%.

But integrating capital markets is a formidable legislative and regulatory task. America has 50 States, and each has its own power to make securities and company law. But your States have the same legal tradition and your laws are written in the same language.

In Europe we have 15 different legal systems in 11 languages -- soon to become 25 legal systems in 20 languages -- and our legal traditions are very different. This is, of course, reflected in Europe's different financial systems.

The Commission approach cannot be the full unification of the legal and regulatory environment of financial markets in Europe. Instead, our approach involves fostering competition across

national borders by allowing investors to make informed choices while offering them protection against abuse.

This will increase the amount of funds that can be allocated to investment opportunities by the market. And it will allow market prices to direct these funds to the most productive projects.

We have laid down common standards on disclosure and market abuse, and we are working in the areas of clearing and settlement, corporate governance and audit.

Furthermore, we have adopted a European Company Statute that offers companies an alternative to national provisions. In 2005, we will move to IAS -- the International Accounting Standard. And we are working on legislation to facilitate cross-border reorganizations. Of course, in order to minimize transatlantic frictions we are engaging in regulatory dialogue with the US.

My fourth example of our approach to innovation concerns the market chances of innovation. Patent applications are one important cost factor here.

For decades Europe has had a European Patent Office located in Munich. But we have had no single patent for all those years!

When a company filed for a patent with the European Patent Office, it had an option for coverage in other European states. But in order to take up that option, the patent had to be translated in full. And in the event of conflict, litigation took place at national courts. So many companies did not opt for patenting in all countries.

This year, the heads of State and government agreed to bring in a single patent. It will be granted by the European Patent Office and disputes will be settled by a judicial panel. The patent certificate will be translated only partially. We estimate that this will reduce the cost of applying for a patent by more than 50%.

My last point may sound obvious to a US audience, but not in the EU. Competitiveness comes from EU-wide competition. When a product is put on the market, the primary market test for

European companies is the EU-wide Single Market. There it will be clear whether companies are able to stand up to global competition.

Therefore, we are firmly committed to removing the remaining barriers on the Single Market. This will be decisive if we want to raise our potential growth rate and increase employment levels in the EU. This is why the dynamics generated by the Single Market of 25 countries are so important.

The EU's enlargement

A European Union of 25 Member States is precisely my last topic for tonight. On 1 May 2004 -- less than six months from now -- eight eastern European countries and two Mediterranean countries will become fully-fledged members of the European Union.

This is certainly an event of the greatest political significance. It signals Europe's reunification after 50 years of division.

But I said that I want to stick to economics tonight. And I will stick to economics with respect to EU enlargement too.

In economic terms, enlargement amounts to integrating two areas with a very large gap in income and productivity. The acceding Member States have a within-country income distribution relatively similar to -- if not even more egalitarian than -- that of the current 15 member countries. But their average income level is considerably lower than that of the current members.

The new Member States represent 20% of the population of the present 15 Member States, but only 5% of their GDP. This means that on enlargement, total inequality is bound to rise by about 20% -- twice as much as the increase in inequality due to Spain, Portugal and Greece in the 1980s.

Against this background, as the proverbial two-handed economist, I cannot refrain from saying that enlargement is both a huge challenge and an unprecedented economic opportunity.

The challenge lies in managing a pan-European Single Market of 25 or more member countries and in coping with the increased inequality across the Union.

To function properly, the Single Market requires a set of common rules and policies in a number of areas. And one requirement for accession to the European Union is that new Member States countries must adopt and be able to implement the full body of Community legislation.

Of course, this has placed an immense administrative burden on the newcomers and the real challenge will come when the rules have to be applied in full, immediately upon membership.

At any rate, however big the challenge to implement the regulations in full may be, the new Member States' smooth integration into the Single Market will be decisive. It will give investors and consumers' confidence that, in the enlarged EU, they can rely on the same set of tried-and-tested rules from the very start.

After enlargement, for the first time in history the EU will have a slightly greater total inequality than that existing between the States of the US. To foster growth in the new Member States and reduce these disparities over time will be a formidable challenge for Europe.

But the history of European integration shows many examples of impressive economic convergence. Italy in the sixties and seventies, Spain and especially Ireland in the nineties have all enjoyed a period of sustained growth as a result of a combination of market forces and EU and national institutional design.

On the other hand, the opportunity lies in the establishment of a large economic area encompassing around 500 million consumers. With the proper legal framework in place, the industrial and commercial opportunities arising from a Single Market of nearly 500 million are immense.

Especially if the current and the future member countries meet the educational and innovation goals I have just mentioned, they will have the human and physical resources they need to draw the full benefit from these new opportunities.

I am confident, therefore, that the forthcoming enlargement will produce substantial macro-economic gains throughout Europe. The new Member States represent only 5% of the GDP of the current 15 members. But their rate of annual economic growth is twice that of the current EU Member States.

Not surprisingly, most economic studies show that the different size and dynamism of the two areas will result in greater macro-economic gains in the new Member States than in the current members. Estimates indicate a positive impact of some 5 to 8 percentage points of GDP for the

new EU countries, and slightly less than 1 percentage point of GDP for the current EU members as a whole.

However, such estimations take current policies as constant. Enlargement will have other -- arguably even more important -- micro-economic effects. Larger markets will offer consumers greater choice and will make R&D activity more profitable. Enlargement will thus act as a catalyst for competition among both consumers and producers in most European markets.

Improved competition may be able to give a much-needed fillip to economic reforms and to foster change, and may thus lead to a better allocation of resources and therefore to larger growth.

Furthermore, the enlargement-related boost to investment and productivity may lead to the creation of a truly efficient pan-European industrial organization, some examples of which are already visible.
Enlargement will not only help to improve resource allocation but will also reduce risks and uncertainty. The lesson we draw from the financial markets is particularly telling.

First, over the last ten years the new Member States have seen a steady improvement in their credit ratings as the prospect of enlargement has drawn closer.

Second, the new Member States and the remaining accession countries enjoy an "accession premium", since their bonds trade at tighter spreads than equally-rated countries from other parts of the world.

Third, this "accession premium" is larger for the lower-rated countries. This clearly reflects greater investor confidence in the countries' business and institutional prospects as a result of their anticipated accession.

Let me conclude now so that we have ample time for the discussion. After the Second World War our aim was to create peace through prosperity and economic integration. And we have succeeded.

We endeavored to establish an EU-wide Single Market for goods, capital, services and persons. This process is not yet fully complete, but it is well under way. The single currency was meant both to ensure stability for the Single Market and as a political project in its own right. The euro has been a success and it has brought Europe economic stability.

But there is still work to do to revive growth. Today I outlined two key elements to that: our innovation strategy and the EU's enlargement next May.

The process of reforming and enlarging the European Union will no doubt create investment opportunities. A more dynamic Europe will thus be to the benefit of us all -- on both sides of the Atlantic.

Thank you for your attention.