Mr Noyer considers the international impact of the euro

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Introduction

First of all, I should like to thank you for giving me the opportunity to address such a distinguished audience.

The topic I shall address today - the international impact of the euro - cannot be fully grasped without considering the particular, and to a large extent unprecedented, nature of this currency. By severing the traditional link between money and state sovereignty, the euro has become one currency issued by one central bank in an area of - for the time being at least - 11 states which, in this respect, have become one economy - the euro area. Although the largest single country in the euro area accounts for slightly more than 4% of world GDP, the euro area as a whole accounts for 15%. This is less than the share of the United States, at 20.5% of world GDP, but around twice that of Japan, at 7.8%. Moreover, the euro area has the highest share of world trade, with a ratio of area-wide exports to total world exports of 19.5%, well ahead of the shares of both the United States and Japan, at 15% and 8.5% respectively.

Given the weight of the euro area in the world economy and the legacy of the former national currencies which have been replaced by the euro, it is no surprise that the euro is the second most widely used currency at the international level. In this respect, the stance of the Eurosystem, consisting of the European Central Bank and the national central banks of the euro area, is based on two basic principles. First, since the internationalisation of the euro is mainly a market-driven process, the Eurosystem adopts a neutral stance, neither fostering nor hindering the international use of its currency. Second, the implications of the international role of the euro for domestic monetary policy will not prevent the Eurosystem from maintaining price stability as its primary objective. Price stability is also a key precondition for a currency to develop an international role. It is a necessary requirement for investors outside the euro area to be confident that their purchasing power will be preserved over time, since price instability constitutes one of the main factors which cause exchange rate and asset price volatility.

In the future, the international role of the euro will eventually hinge on the validity of the fundamental idea underlying its creation, namely the idea that important components of sovereignty can be pooled and shared among nations in the pursuit of common economic and political objectives. Such a belief, of course, lends itself to being challenged, as do all innovative concepts. Money has indeed been the most typical expression of state sovereignty for centuries, so why should this not continue in the future? Moreover, although the link between state and money was no longer seen as an intrinsic necessity, does Economic and Monetary Union (EMU) really work?

Today I shall first try to answer these fundamental questions relating to the “domestic foundations” of the euro. This will be helpful in providing a better comprehension of the international impact of the euro in three specific areas which, in my opinion, are crucial:

- the use of the euro by the business community as an investment and financing currency in the global financial system (market impact);
- the new role played by the euro area in the process of international cooperation (first policy impact); and
- the importance of the euro for the process of regional integration in Europe and Africa, and the role that this process may play with regard to possible integration in other regions of the world (second policy impact).

1. The implications of severing the link between state and money

The link between state and money can no longer be considered to be self-evident. Indeed, there are three plausible alternative options.

A first, nevertheless still hypothetical, option is the privatisation of money. This solution, the most radical, is now becoming conceivable - although admittedly still a remote possibility - as a result of technological innovation. As Mervyn King, Deputy Governor of the Bank of England, recently pointed out, electronic transactions in real time among individuals may someday replace central banks' monopoly over cash and bank reserves. This means that all economic agents would carry out final settlements without the need for clearing by the central bank. However, if such a new system were to develop, this would take some time, since the existing technology is far from being in a position to allow the real-time transfer of e-money from one individual electronic account to another. Moreover, a development of this kind would not only mean the end of the link between state and money; it would also mean the end of money as we understand it today. The fundamental issue is whether it would also mean the end of inflation. I have my doubts. However, I shall not embark upon a discussion of that issue today.

A second option is currency substitution, namely the unilateral adoption, either de jure or de facto, of a typical anchor currency, such as the US dollar or the euro, as legal tender. "Dollarisation", as well as "euroisation", is a policy option open to a wide number of open economies with a high degree of trade and financial integration with the anchor currency. I shall take a closer look at this option in the final part of my speech.

Finally, the third option is super-nationalisation of money à la Mundell. This is the path which was followed by 11 Member States of the European Union (EU) when they adopted the euro one year ago. But why the citizens of the European Union, and why only at the end of the 1990s?

The main argument is that the more a process of regional integration moves beyond a free trade area towards a single market, or even an economic union, the stronger the need for intra-area exchange rate stability and, eventually, irrevocably fixed exchange rates. This causes a conflict with the autonomy of monetary policy at the national level, thus creating the need for monetary union. This is exactly the situation that characterised the EU at the end of the 1990s, as a result of the long process of integration initiated more than 40 years previously. The EU is indeed an area where there is not only full mobility of goods but also of capital and, at least in principle, labour; subsidies and regulations which favour domestic producers are not permitted; there are common or coordinated policies governing several fields. In an area with these characteristics, cross-border demand for similar products produced in different member countries is sensitive to price changes. This implies that a major change in the exchange rate would shift competitive advantages within the area, thus having an impact on profitability and triggering political reactions.

In addition, a number of specific economic features of the euro area strengthen the case for intra-area exchange rate stability and, ultimately, monetary union. First of all, most of the trade carried out by individual euro area countries takes place with other euro area countries. All these countries present a rather homogeneous commodity composition of production and trade, unlike the North American Free Trade Area (NAFTA), where Mexico and Canada are relatively heavily dependent on the production and export of primary commodities. In the euro area, therefore, the first effect of intra-area exchange rate fluctuations would be to distort competition across firms located in different countries and producing similar products, rather than to adjust shifts in the demand and supply of different products through changes in their relative prices. In addition, individual countries in the euro area are very open to international trade. The degree of openness, as measured by the average of exports and imports of goods and services as a percentage of country GDP, is around 30% on average and exceeds 60% in smaller countries such as Belgium and Ireland. The more a country is open to international trade, the more likely it is that a depreciation of its exchange rate will lead to inflation over the medium term, without any significant improvement in its competitive position.

These arguments are, in my opinion, useful in explaining why, just one year ago, the citizens of the EU initiated the so-called "Stage Three" of EMU.

Stage Three does not only entail the introduction of the euro, but also the adoption of a new institutional and operational framework for economic policies in the euro area. According to this new "balance of powers", monetary and exchange rate policies are conducted at the area-wide level. In this context, the primary objective of the Eurosystem is to maintain price stability. Without prejudice to this objective, monetary policy also supports the general economic policies in the euro area. The monetary policy stance is decided by the Governing Council of the ECB. This Council comprises the six members of the Executive Board of the ECB and the 11 governors of the national central banks which have introduced the euro. The members of the Governing Council do not represent their respective country or national central bank, but act in a personal capacity with responsibility for the euro area as a whole. By contrast, certain other economic policies continue to be set in a national context. Fiscal policies, however, must be formulated in accordance with the so-called Stability and Growth Pact. By signing this Pact, the Member States which make up the euro area agreed to reduce their general government deficits to close to balance or even to create a surplus in the medium term. This is intended to enable automatic stabilisers to work throughout the economic cycle, while simultaneously observing the limit of 3% on the public deficit/GDP ratio, as laid down in the Maastricht Treaty. Structural policies remain the main instrument available at the national level; however, certain forms of multilateral surveillance are being promoted even in this field, although in a less defined form than that adopted for fiscal policies.

In his famous article of 1961, Nobel Prize winner Robert Mundell not only provided the economic rationale underlying EMU, but also provided the criteria to assess, subsequent to the start of EMU, what types of behaviour and economic developments are needed to allow it to function properly. In particular, as we well know, the euro area needs more flexible labour, product and services markets, which in turn means more active structural policies. What does this imply for the functioning of EMU? Three considerations apply in this respect. First, neither the euro area as a whole, nor any major country in this area, nor larger economies such as the United States fully meet the Mundell criteria. In practice, it is almost impossible to find an optimal currency area - rather, this is a benchmark to be observed by the policymakers of each currency area. Second, shocks tend to be asymmetric between regions and sectors much more frequently than across nations. When shocks occur at the international level, this typically stems from divergence in economic policies, but this is becoming less likely in the euro area thanks to the aforementioned forms of policy coordination. Third, by eliminating intra-area exchange rate risk and boosting price transparency, the introduction of the euro is likely to enhance market competition, thereby adding to pressure for labour market and other necessary structural reforms. This means that EMU fosters the development of the euro area in line with the model of an optimal currency area.

Against this background, I believe that the euro can rely on very solid domestic foundations. This is likely to encourage its further internationalisation. With regard to the exchange rate of the euro, I should like to say the following: at the moment the European economy is clearly recovering and the outlook is favourable. As a consequence, the euro has great potential for appreciation. This potential is also firmly based on internal price stability and a sound current account position.

2. The international use of the euro as an investment and financing currency

Although the international community makes use of the euro for several other reasons (such as payment, pegging, etc.), the utilisation of this currency in the global financial market is the driving force behind its internationalisation. In particular, the advent of the euro is speeding up the process of integration and innovation in the euro area domestic financial market, which may in turn influence its international use. This means that the euro has not simply replaced the various national denominations within the given market structure. Its introduction may determine a "shift of regime" in financial markets, which would imply that market participants may fundamentally revise their strategies in response.

Although only a very preliminary assessment is possible at this stage, figures currently available on the international use of the euro as an investment and financing currency seem to confirm this impression.

With regard to the field of international debt securities issuance, in 1999 the euro was more widely used than its legacy currencies had been before 1998. This fact has emerged from the data published by the Bank for International Settlements, which single out the truly international component of euro-denominated issues. According to this statistical source, in the first three quarters of 1999, euro-denominated gross international issues of money market instruments, bonds and notes accounted for 38% cent of total issues, just slightly below the share of the US dollar (41%). By comparison, in the first nine months of 1998 the combined share of the former euro area national currencies and the ECU was only 24% of total gross issuance. Of course, one-off factors may partly explain the development of the euro: issuers may have deliberately postponed deals arranged in 1998 until after the “changeover weekend” and increased issuance activity in order to create liquid benchmarks. However, issues in euro have been growing continuously over the whole year, so other factors are also likely to have played a role.

In my opinion, one of these factors may be market expectations concerning the future development of the domestic euro area financial markets. The introduction of the euro, in fact, involves a process of integration of national financial markets of the euro area into an area-wide single market, the size and liquidity of which will exceed that of the constituent markets. This implies a reduction in transaction costs and greater choice of financial instruments, which make the euro attractive as a vehicle for portfolio diversification. A virtuous circle may therefore develop - the increasing international use of the euro as an investment and financing currency may feed back into the depth and breadth of Europe’s domestic financial markets, thus encouraging further restructuring of the euro area financial system.

Evidence shows that the euro area money market is already highly integrated and liquid. Significantly higher trading volumes in this market have already led to lower bid-ask spreads for very short-term maturities. Efforts to integrate national securities markets and settlement systems are under way. The euro is also increasing competition in the banking sector, thus strengthening existing trends towards securitisation, as well as consolidation and/or disintermediation in this sector. Securitised financial instruments are easier to trade internationally. Furthermore, the unprecedented size of mergers and acquisitions within the euro area is encouraging the development of a large domestic market for corporate bonds. Even a high-risk market segment comparable to the US “junk” bond market is likely to emerge within the euro area over time.

It should be acknowledged, however, that a number of obstacles to the full integration of euro area financial markets still remain. Separate national fiscal policies lead to discrepancies in credit and liquidity risk premia across the area. Equity markets and securities settlement systems are still segmented. Differences in financial market conventions persist. Hence, the short-term liquidity and efficiency gains are smaller than a simple aggregation of national markets would suggest. Most of the potential gains will only materialise fully over time.

3. The impact on cooperation at the global level

The introduction of the euro also has implications for the international cooperation process. By reducing the number of key global players, the emergence of the euro area in principle simplifies international cooperation, as it facilitates the exchange of views and the formulation of common understandings on economic and financial issues. A more balanced relationship between the three major players - the United States, the euro area and Japan - is helping to encourage each of these to take responsibility for contributing to a stable global environment.

The European single currency may also foster the emergence of a tripolar monetary framework based on the US dollar, the euro and the Japanese yen. Policy coordination at the global level, however, is likely to continue to be of a non-binding nature in the future. Following the collapse of the Bretton Woods system, larger countries have always refrained from committing themselves to formal exchange rate arrangements or other pre-defined rules. In this respect, the introduction of the euro has not changed the current picture.

This does not mean that exchange rate stability is not desirable worldwide. In my view it is, not least because abrupt changes in exchange rates may generate calls for protectionism and for restrictions on capital flows, which eventually erode free trade and capital mobility. Stable exchange rates, however, cannot be achieved by setting ranges of fluctuation for the major currencies (target zones). The key to sound international monetary relationships has to be found, instead, in sound domestic policies and institutions.

Efficient and effective international cooperation means that the euro area needs to be able to take a single position when appropriate. In line with the present allocation of responsibilities among euro area Member States, the Eurosystem and European Community institutions, pragmatic arrangements for the external representation of the euro area in international organisations (IMF, OECD, BIS, etc.) and forums (G7, G20, etc.) have been already implemented. Of course, the euro area is not always able to speak with a single voice as in the case of the United States. However, given that the allocation of responsibilities within the euro area and the scope of Community policies are likely to evolve over time, the external representation of the euro area will probably make progress in the future and this should therefore be considered to be an ongoing process.

4. The process of regional integration in the euro time zone and its implications for other regions in the world

A further policy implication of the advent of the euro concerns the process of regional integration within the so-called “euro time zone”, which, roughly speaking, comprises 100 countries in Europe, the Mediterranean area and Africa.

The degree of economic and institutional integration of the euro area with this zone is relatively high.

There is highly developed integration with the four EU Member States which have not yet adopted the euro as their currency, i.e. the United Kingdom, Sweden, Denmark and Greece. Relations with these countries are organised within the framework of the EU. The EU’s past experience shows that economic and institutional integration in a region can successfully go beyond the establishment of a free trade area, as in the case of NAFTA, or a customs union, as in the case of Mercosur. It also a way in which regional integration can be achieved.

Moreover, the European Union is the relevant counterpart for institutional relations with other country groupings within the euro time zone: the European Free Trade Association (EFTA); Central and Eastern Europe including the Balkans; the Mediterranean area; and the African, Caribbean and Pacific (ACP) countries. For each of these groupings an ad hoc arrangement has been put in place, which often goes well beyond trade liberalisation and covers final objectives such as the free movement of capital, services and labour, cooperation on issues such as social policy and environmental matters, and EU accession.

While many of these arrangements have a long-standing history, the introduction of the euro implies new monetary relations, which, however, benefit from the heritage of former national currencies such as the French franc and the Deutsche Mark. In this respect, 34 countries in the euro time zone have an exchange regime involving the euro or its national denominations. The solutions adopted are very different and range from the use of Deutsche Mark banknotes as a parallel currency to pegging against either the euro or a basket of currencies which comprise the euro, and from the adoption of currency boards to managed floating using the euro as an informal anchor. In particular, the 13 EU accession countries are among those countries for which pegging vis-à-vis the euro is an issue. Having started from a variety of exchange rate regimes, usually already involving the euro, these countries are currently building the policy frameworks and institutions that may one day allow them to sustain exchange rate pegs against the euro.

The experience of monetary integration in the euro area indicates that the choice of an exchange rate regime depends to a large extent on the medium and long-term perspectives for economic and institutional integration in a given region. As I have already pointed out with regard to the euro area, the more advanced regional integration, the higher the need for exchange rate stability. This shows that, to a certain extent, the need for stable exchange rates not only depends on a number of objective parameters which are exogenous for policymakers, but also largely depends on the political willingness and ability to carry out such a process of regional integration. This explains why, from the point of view of the EU accession countries, the desirability of exchange rates anchored to the euro should not be considered from a merely static point of view (its present desirability), but also from a dynamic point of view (its prospective desirability, in view of the process of integration). In this respect, there is no doubt that, following the fall of the Berlin Wall, the process of integration between the EU and the accession countries has been proceeding rapidly in such crucial areas as trade policy, current account convertibility, capital flows and political dialogue.

In this context, let me digress to the current debate on dollarisation in Latin America and, in particular, Argentina. As a response to the severe recession in the wake of the emerging market crises in 1997-98, the possibility of an official dollarisation of the Argentine economy has been discussed intensively in both political and academic circles. Such a solution would imply the removal of the US dollar-based currency board arrangement which was adopted in 1991 and which has served Argentina well over the past few years.

If a country wishes to adopt unilaterally a stable foreign currency as legal tender, several factors should first be taken into consideration. On the real side, the small size of an economy and a high degree of openness combined with predominant trade and financial links to the country issuing the anchor currency are factors in favour of the adoption of a foreign currency. On the monetary side, a history of high inflation and a high level of currency substitution, i.e. a high level of unofficial dollarisation, could become an additional incentive for governments to move to official dollarisation. This in turn would eliminate the exchange rate risk and reduce the corresponding risk premium in domestic interest rates to the extent that it is not related to non-devaluation sovereign risk. Finally, on the financial side, the existence of a sound domestic banking system and the extensive presence of foreign competitors in this sector could also be regarded as preconditions for the move to dollarisation.

The de facto "unilateral monetary union" which official dollarisation in Argentina would imply would be different to the process which led to EMU and the present negotiations for EU accession.

For the Argentine authorities, the potential benefits of dollarisation are mainly related to the one-off gain in anti-inflationary credibility. In the short term, official dollarisation would eliminate the exchange rate risk and thus reduce the currently high domestic interest rates to levels closer to those of the US. This would help break the vicious circle of high real interest rates and the increasing borrowing requirements which are causing larger fiscal and external imbalances.

In the long term, however, the objective of closer regional integration has to be taken into consideration. Given the country's trade policy which is geared towards Mercosur, notably Brazil, and Europe, the decision to move towards official dollarisation would have to be consistent with the medium and long-term prospects for enhancing regional integration. At present, coherent intra-regional exchange rates for the Latin American region as a whole depend, inter alia, on whether the inflation target strategy recently adopted by Brazil will contribute to realistic and stable exchange rates of the Brazilian real vis-à-vis the US dollar.

Conclusions

I shall bring this talk to a close by drawing three main conclusions.

First, although it is not the end of the process, the introduction of the euro can be considered to be a major milestone in the long process of integration initiated by the European Community more than 40 years ago. Moreover, the euro can be confident that it rests on extremely solid foundations.

Second, the international use of the euro and the role of the euro area in international cooperation are likely to develop further, in line with the relative position of the euro area in the world economy and the institutional and political integration of EU Member States.

Finally, the original formula as a result of which Europe operates as a regional organisation may become a point of reference with regard to possible integration in other regions of the world, although it has to acknowledged that specific historic and cultural factors determine the European integration process.