Mr O'Connell gives a review on the euro and the European Central Bank and makes a few brief remarks on the world economy

Statement by Mr Maurice O'Connell, Governor of the Central Bank of Ireland, to the Irish Parliament's Joint Committee on European Affairs, Dublin, on 23 February 2000.

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Before I speak about the euro and the European Central Bank, may I make a few brief remarks on the world economy. The outlook is quite positive. The US economy has surprised even the most optimistic of observers. Growth was of the order of 4% last year and inflation remains low. Europe appears to have turned the corner and to be on a path of stable, if unspectacular, growth. The European economy should expand by 3% this year and this should be sustained in 2001. The Far East generally is recovering, though the recovery in Japan appears to be very tentative.

As always, there are risks. In the US, factors such as the persistent balance of payments deficit or a declining stock market could undermine success. Europe must address vigorously the structural deficiencies that are a dead hand on the economy. Japan has yet to demonstrate convincingly that reforms, including consolidation of the financial sector, are beginning to work.

At the international level generally, the succession of economic crises in recent years has prompted the authorities to review comprehensively the whole international financial architecture. Central to this response have been efforts to improve the quality and availability of economic and financial data and strengthen financial regulation. This is underpinned by institutional developments, such as the creation of two new bodies - the Financial Stability Forum and the G20. This is not today's subject. I mention it, however, because there will be changes ahead which will enforce new standards of regulation and transparency worldwide.

The euro

It is against this background that we should assess the progress of the euro. The new currency is now in its second year. It is an accepted element of the international financial system, being the second largest currency - second only to the US dollar and ahead of the yen. The euro area has an internal market of about 290 million people, some 20 million more than the US. Exports from the area account for almost 20% of world exports. In 1999 the euro became the most popular currency for new bonds in international markets, accounting for some 45%, compared with 42% in US dollars.

While the launch of the euro has been a remarkable success, the first year has not been without difficulty. During 1999, it weakened by 14% against the dollar, while, in overall terms, the effective exchange rate was down by about 13%. Currency developments largely reflected an unexpected divergence in economic performance between the US and the euro area. Growth in the US economy accelerated beyond expectations in 1999, while the expected recovery in the euro area economy was slow. Stock markets in the US lent further support to the dollar while outward investment from the euro area weighed on the euro. It was also weighed down by the impression that structural impediments were retarding economic activity in Europe. Besides, it did not help matters that, in the early days, there was a variety of spokespersons with different prescriptions for the new currency. Most commentators accept that the currency is now significantly undervalued and that the tide will turn.

The question is sometimes asked whether the absence of political integration is a drawback to the currency. Perhaps there is some disadvantage; all other major international currencies are underwritten by political union. I would not wish to exaggerate the significance of this.

The integration of financial markets within the euro area is going ahead at different speeds in different markets. While the money market has been unified quickly, the bond market is still not fully integrated. Market structures differ and most of the smaller countries do not have sufficient issue sizes to achieve benchmark status. Investors have a preference for the larger markets, where there is greater liquidity. This is not to our advantage.

Equity markets are least advanced in terms of integration. For many stocks, national considerations are still important. In time, however, trading may become concentrated in a small number of larger centres and the existence of small equity markets may be put in doubt. In this context, the ability of national markets to be competitive, especially in terms of transaction costs, will be a very important factor. EMU has brought these issues of competition to the fore and increased the urgency of resolving them successfully. These developments are a source of concern to us because of the tendency towards centralisation.

The European Central Bank is realising its primary objective, which is to maintain price stability within the euro area. Although the Harmonised Index of Consumer Prices (HICP) rose by 1.7% in the year to December 1999, this was boosted by a rise of over 10% in energy prices. While the Bank does not target an exchange rate for the US dollar or any other currency, it would be entirely wrong to imply that it pursues an attitude of benign neglect or is indifferent to the exchange rate. A strong euro is in Europe's interest and in Ireland's interest. The more stable it is at home, the better its prospects on the international stage.

Credibility is never easy. In the normal course, it is built on a good track record. One obvious measure of credibility for a currency is long-term interest rates. In this respect the euro is faring well. It is evident that the financial markets believe that stability will be maintained within the euro area.

Ireland and the euro

The Irish economy is just one percent of the total euro area economy. It follows that Irish experience will not greatly influence nor dictate policy. Our experience up to now has been decidedly different from that of the euro area generally, because of the scale of economic growth here in recent years. As a consequence, we have had to adjust to a monetary policy which, in the short term, is not well suited to Irish conditions. There is nothing that we can do about this in terms of tightening monetary policy. We cannot raise interest rates unilaterally to suit our circumstances. While euro interest rates have risen in recent months, they remain substantially below what the Central Bank would consider as appropriate here in the present buoyant conditions. There is no longer an Irish exchange rate. We cannot impose formal ceilings or restrictions on the growth in credit, which is running at a very uncomfortable rate. We do require the lending institutions, however, to observe good prudential standards.

As monetary policy is no longer determined to suit Irish conditions, our economy is more vulnerable than before to overheating and the consequences of this - inflation and a loss of competitiveness. The Central Bank's ability to take corrective action is severely restricted. A greater onus is now placed on other factors, such as fiscal and incomes policies. In particular, there is a greater need to use fiscal policy to contain strong demand. Continuing economic success must not blind us to the reality that we are in a new regime which, sooner or later, may demand from us disciplines to which we are unaccustomed.

Because of the uncertainties linked to sterling, it would be to our advantage if the UK were to join the euro area sooner rather than later. The indications are, however, that the UK is unlikely to become a member at an early stage. Besides, if it should decide to join, it will presumably have to satisfy entry requirements in relation to the exchange rate and central bank independence. Sterling has been very strong against the euro, contrary to earlier expectations. This is to our advantage in the short term to the extent that it facilitates exports. It also raises the prospect of importing inflation. Taking a longer-term perspective, we need to be prepared for the possibility that in due course a declining sterling may intensify competition.

European Central Bank

Decisions on monetary policy issues in the euro area rest with the Governing Council of the European Central Bank. Within the requirement of price stability, the Bank also has a duty to facilitate growth and employment. Stability has been defined by the Bank as an inflation rate not exceeding 2% in the medium term. The Bank also has a reference value for monetary growth as part of its overall strategy. I said already that the Bank does not target an exchange rate for the euro. Obviously, if the rate were seriously out of line with economic realities or if there were extreme volatility, there would be some corrective action. This would not arise in normal circumstances.

In the European Central Bank there is a genuine commitment to transparency. This is reflected in the extensive published information and in the regular and detailed press briefings. The President attends before the European Parliament. He is also present, as required, at meetings of EcoFin and the Euro-11 Ministers. Some members of the Governing Council attend periodically before their national parliaments. It would serve no useful purpose, in my opinion, to publish minutes of Council meetings and the voting records of individual members. This could inhibit discussion and possibly impose undue pressures on members to reflect a national viewpoint. This would be contrary to the spirit and the letter of economic and monetary union.

Reserves

On the previous occasion that I came before this Committee, I referred to the perception that there would be a large surplus of free reserves when we joined EMU. This is a rather complex subject. The position is as follows.

We have already contributed 467 million euro to the capital and foreign reserves of the European Central Bank. In practice, we retain and manage these funds here. They do not belong to us; they belong to the ECB. In addition, we hold and manage our own foreign exchange reserves and euro assets which, at the end of 1999 totalled nearly 7½ billion euro. On top of this, we also have assets arising largely from the conduct of the money market. In short, the total assets of the Bank amount to 12.75 billion euro. For the greater part, these are matched by liabilities in the form of currency, bank deposits and Government deposits. The excess of assets over liabilities is represented by capital and internal reserves. These totalled 2½ billion euro at end-1999. This is the figure to which the term “free reserves” is applied. This is the capital which supports the Bank. It is also a buffer against changes in the value of external reserves, arising from movements in the euro vis-à-vis other currencies. Relative to the size of our balance sheet, this figure is at the lower end of the scale vis-à-vis other euro area national central banks.

The national central banks in the Eurosystem no longer conduct foreign exchange intervention. It is fair to ask, therefore, whether they now have surplus external assets. There is a recognition that this question should be addressed in due course. These reserves are subject to call by the European Central Bank. In all likelihood it will make a further call for additional capital and foreign reserves. It would seem preferable therefore that the issue of superfluous reserves be settled at the general European level rather than taking unilateral action.

Our external reserves are denominated, for the greater part in US dollars and to a much lesser extent in sterling and yen. There is also a small quantity of gold. The reserves are invested in deposits and securities and are managed by reference to an independent benchmark. The Central Bank has a very good record in managing large-scale funds. In respect of 1998 we earned a surplus of 225 million euro (IR£177 million), mainly from investment of reserves and interest. Of this, 193 million euro was transferred to the Exchequer.

Banknotes and coin

To most people the euro probably remains largely academic until it is available in their pockets. It is still considered a currency in transition. In less than two years from now the new banknotes and coin will have begun to replace national currencies. The impact will be huge at local level; immediately the euro will become the concern of everybody. May I remind you that the largest banknote will be 500 euro (roughly £400) and the smallest coin will be one cent (which is 4/5 of a penny). There will be seven banknotes and eight coins.

Our production arrangements are already well in hand. In recent years we have invested more than £30 million in new plant and machinery. Coin production is under way since last autumn; we plan to begin the production of euro banknotes in April. We must provide, for our own initial needs, almost 200 million euro notes and over 900 million coins. We also must maintain an adequate supply of Irish notes and coin up to the end of next year. Despite the competition from electronic money, the demand for notes and coin continues to well exceed the growth in the economy. There have been some reports in recent months about a shortage of coin. There are 2,400 million coins in circulation. Last year we issued 236 million, which represents 60 additional coins for every person in the country.

Overall, the entry into EMU has had a profound impact on organisation and work practices in the Central Bank of Ireland. The euro is now the currency of the State. The Irish pound is now a denomination of the euro and it is no longer traded on the foreign exchange market. There is constant daily interaction with the European Central Bank. Our personnel serve on a wide range of European Central Bank committees. The Eurosystem is quite unique; while policy is determined collectively in Frankfurt, it is implemented on a decentralised basis by the national central banks. It is important that this emphasis on decentralisation is not eroded over time.

The Irish economy

I have said earlier that within the euro area Ireland continues to be the grand exception because of our rate of economic growth. Studies undertaken by the Central Bank suggest that, for the medium term, we have the capacity to sustain a growth rate of the order of 4-5%. This is about twice the estimated potential growth rate for most European economies. The exceptional growth over and above this for the past few years was made possible by a high degree of slack in the economy and in particular, by a rather low employment rate. This good performance contributed to a welcome increase in living standards and employment. Now, however, there is mounting evidence of overheating in the domestic economy. This is reflected in exceptionally rapid increases in property prices, unprecedented demand for credit, labour shortages, higher inflation in the services sector and chronic congestion in the physical infrastructure.

During the past year, there has been a marked disimprovement in our inflation performance, both in absolute terms and by reference to our main trading partners. In January, the rate of inflation here, as measured by the HICP, the benchmark index for euro area comparisons, was 4.4%. This was two and a half times the rate prevailing in the euro area as a whole. This puts us at the top of the league table. Some of the rise in headline inflation can be ascribed to once-off or temporary factors - such as the rise in excise duty on cigarettes, higher oil prices and weakness in the euro. There is, however, a strong rise in underlying inflation which for the most part reflects the existence of strong demand.

Nobody claims that inflation here must be at precisely the same level as in the euro area generally. It is reasonable to expect some differential at this time in view of our economic conditions but there are obvious limits. The point I want to emphasise is that, if present trends persist, we may have a sharp loss of competitiveness on our hands.

One of the inevitable consequences of an integrated European economy and a single currency is the strong tendency to centralise financial activities in the larger centres and an increase in cross-border competition. This is a threat to the Irish financial services industry, which has been expanding vigorously in recent years. It is compounded by the pressures within the industry for mergers and acquisitions, which are driven by new technology and the perceived benefits of economics of scale. I would like to believe that in ten years from now we will continue to have a vibrant indigenous financial services industry. I would be optimistic that the International Financial Services Centre will continue to grow and evolve as an integral part of our financial system.

Conclusion

After years of preparation, EMU is now a reality. In time, we will undoubtedly benefit from being part of an economy whose currency has a leading international status. We will benefit also from internal price stability and the security that this brings. We must not lose sight of the reality, however, that membership of the euro area also imposes new disciplines, which will be put to the test at some stage. There is no provision in the Eurosystem for a bail-out in the event that any member encounters serious economic difficulties. We can no longer fall back on the exchange rate or interest rates. We can no longer control credit. These options are gone. Having said this, the advantages of being part of the euro area should well outweigh the disadvantages in the long term. I am confident that we will come to realise this more and more as time goes on.