Guy Quaden: The euro after two years

Speech by Mr Guy Quaden, Governor of the National Bank of Belgium, at "De Hanze" International Club of West-Flanders, held id Bruges on 11 January 2001.

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Since the changeover to monetary union on 1 January 1999, economic activity in the euro area has accelerated considerably. The year 2000 brought growth rates (of the order of 3.5 p.c. on average for the euro area and 4 p.c. for Belgium) which we had not seen since the end of the 1980s.

Of course, this improvement was not due solely to monetary union. The international climate has become more favourable; following the 1998 crisis, Asia, in particular has seen a recovery and in the United States economic activity remained at a high level until the past few months.

But the introduction of the euro has undeniably contributed to renewed growth in our countries by creating a far more stable economic framework. This was achieved by irrevocably fixing the parities between 11 and with the Greek dragma now 12 currencies, curbing inflation (a constitutional objective of the European Central Bank) and limiting budget deficits (required by the European Stability and Growth Pact).

In 2000, the exchange rate of the euro against the dollar was much discussed. But there are some exchange rates which, fortunately, no one talks about at all any more: e.g. that of the Belgian franc against the German mark or the Italian lira, or the French franc. That kind of monetary instability has been totally eliminated for ever, since the introduction of the euro, but it was what caused our economy the most problems, since the bulk of our companies' foreign trade is with other European countries. Our foreign trade with the other countries in the euro area has become domestic trade which is paid for in our common currency, the euro.

The considerable extra stability created by the euro was particularly marked in Belgium's case. You will remember that, a few months after the introduction of the single currency, our country suffered a specific economic shock: the dioxin crisis. If the macroeconomic consequences of that crisis were minimal, then that is thanks to the euro. Without the euro, the exchange rate of the Belgian franc would most likely have come under pressure, and the National Bank would have had to respond by increasing its interest rates. The crisis would then have had an impact extending far beyond the sectors directly affected.

After a temporary slowdown in activity, the prospects for the coming year remain good. Most institutions agree in predicting a growth rate of the order of 3 p.c. for the euro area and for Belgium. Though this is not as high as in 2000, it is still very satisfactory in historical terms.

Admittedly external uncertainty has recently increased with regard to the quality of the landing of the US economy. This might be somewhat abrupt. But a real recession remains improbable and the American authorities that are in charge of economic policy have already demonstrated their resolve to react without delay.

Above all, internal demand in the euro area, which represents 85 p.c. of final expenditure remains robust. In Belgium, which is often regarded as indicative of future developments in the entire euro area, after the decline in both confidence of enterprises and consumers in September at the time of the oil crisis, confidence of enterprises has been rising again at the end of the year and consumer confidence has once more reached a historic peak. The latter is borne by a steady decline in unemployment and by job creation and also by the prospect of inflation coming down once more to a low level after the increase in the autumn.

The oil price rise has not seriously disrupted growth prospects. We can call it a "mini oil crisis". First, the rise, though rapid (recovering from a position where prices had fallen excessively low) was not comparable with the price increases of the 1970s. Also, our economies have become less dependent on oil (by the exploitation of new energy sources, the energy-saving measures which were implemented for a time and the shift in economic activity towards the service sector). Finally, the mistakes made in economic policy 25 years ago were fortunately not repeated. The suspension of index-linking of incomes –or in Belgium, the use of an adjusted price index– has made it possible to avoid a new inflationary spiral of prices and wages and governments have limited the compensatory budget measures.

The European Central Bank, which is now in charge of monetary policy, has done what it should. Naturally, it could not prevent the oil price rise from causing inflation to worsen temporarily, but it had to prevent inflationary expectations from snowballing. That is why it raised interest rates several times last year.

The aim of the European Central Bank is to maintain the confidence of the economic players in price stability in the medium term. And it is apparently succeeding because, despite the oil price rise, long-term interest rates –determined by the markets on the basis of the inflation outlook– did not increase in 2000.

Monetary policy has kept inflation down but without destroying growth. Even now that they have been raised, the interest rates of the European Central Bank cannot currently be regarded as damaging economic growth, because real short-term interest rates (nominal interest rate minus inflation) are now no higher than when monetary union was launched at the beginning of 1999 (during the first quarter of 1999 the key benchmark rate was 3 p.c. and inflation in the euro area was 0.8 p.c.).[1]

The euro's internal value (its purchasing power) has been safeguarded by the actions of the ECB, but we must admit that the trend in its external value has been less satisfactory.

The relatively weak exchange rate of the euro has naturally favoured European exports, but that is a short-term advantage, because an economy's competitiveness needs to be based on factors other than a weak currency. Furthermore, it has increased the cost of our imports. We have realised that as oil prices have risen, so that is a factor which can push up inflation. And if the exchange rate continues to weaken, that could in the long run impair savers' confidence in this new currency, both in Europe and beyond. There was a time when one dollar cost over 3 marks and so the mark has been weaker against the dollar than the euro. And at that time no one ever viewed the mark as a bad currency. But it is true that the mark could boast of a long history and that no one in that instance doubted that the international currency fluctuations would change direction one day.

The differences in economic growth and interest rates between the United States and the euro area could to some extent explain the depreciation of the euro against the US dollar.

But last summer we, the members of the Governing council of the ECB, repeatedly said that the fall had become excessive and unjustified. We also said that intervention on the foreign exchange markets could not be ruled out. By actually intervening we gave the markets two signals: first, that even if the internal value of the euro is the only objective to which it puts a figure, the ECB is not indifferent to the euro's exchange rate (and to demonstrate that, actions speak louder than words); also, it should be clear that this rate does not necessarily move in one direction only, that it is not a one-way trend.

Recently, the markets do seem to have become more realistic once again; they are no longer considering only the good news about the dollar and the bad news about the euro, as was the case at one time.

The euro exchange rate is beginning to recover; the extent of the recovery will depend mainly on the convergence of growth rates on either side of the Atlantic and continuing consolidation of the European economies.

Of course, the improvement in the euro exchange rate should preferably be based not on the-transient- weakness of the American economy but on the lasting strengthening of the European economy. Fortunately, the structural reforms are gaining ground in Europe: new technologies are steadily making progress; competition on the markets has increased and labour markets are becoming more flexible, even if such a statement is taboo. Now that government finances are also being put in order, scope is gradually being created for reducing the fiscal and parafiscal burden in Europe. That is important because the burden is currently much higher in Europe than in the United States.

It is time to conclude.

Internationally, just as the notes and coins are about to be introduced, 2001 could become the year of the euro. The euro is only two years old, so it is still in its infancy and needs to grow up, but it is already sturdy and indeed looks older than it is. As we have seen, it has helped to boost growth and employment in Europe. It has proved itself on the financial markets, but many people still see it as a virtual currency because it does not yet exist in tangible form.

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1 Today the official interest rate stands at 4.75 p.c.; inflation ran at 2.7 p.c. during October 2000 and 2.9 p.c. in November for the euro area, and was probably lower in December.

On its third birthday it will at last take on the form of notes and coins, which will circulate from Helsinki to Lisbon via Bruges. Europeans will then become fully aware of the fact that they have a common currency, which is already the second most widely used currency in the world.