

Christian Noyer: First experiences with the euro

Speech by Christian Noyer, Vice-President of the European Central Bank, delivered at the International Center for Monetary and Banking Studies, held in Geneva, on 20 March 2001.

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Ladies and Gentlemen,

I am pleased and honoured to be able to speak to such a distinguished and varied audience today. I am sure you will appreciate in what an exciting and important time we are living. In slightly more than nine months, the euro banknotes and coins will be in the hands and pockets of all citizens of the participating Member States. The euro will thus become tangible in the personal dealings of 300 million Europeans and cease to exist only on computer screens or in the press headlines. Travelling from the sunny islands of the Mediterranean to the icy lakes of Scandinavia will no longer require any stop at a bureau de change. This is no little achievement, to my mind.

While the introduction of euro banknotes and coins will certainly bring about a quantum leap in people's acceptance of the euro and change their psychological attitude towards it, we should not forget that a great deal has already been done and that Monetary Union is already fully-fledged reality. I am by no means an impartial observer, but I think that the first two years of Monetary Union have been a success. I hope to have convinced you of that by the end of my talk. The euro - the crowning achievement of the Single Market programme - has de facto created a common market of 300 million consumers, one of the two most important economies in the world. This reinforces the possibilities for producers to exploit the economies of scale that - at least since the work of Adam Smith - are regarded as one of the main engines driving economic growth and technological progress. Competition is being fostered and will be fostered even more in the future by the increased price transparency that the introduction of euro banknotes and coins will bring about.

During the first two years of Economic and Monetary Union (EMU) in Europe, we have dealt with the difficult task of consolidating a new central bank, the European Central Bank (ECB). This has been by no means easy, also because the ECB plays a role of global importance and is continuously in the limelight of public attention. In my view, the ECB has proved to be very well equipped to tackle the challenges it is confronted with in a successful manner. An important contribution to this is to be attributed to the drafters of the Treaty, who have devised an institutional setting which is optimal for the maintenance of price stability and the achievement of high levels of economic growth and welfare in the euro area. I will come to that in a moment.

The transition to Stage Three of EMU in 1999 was a complete success from a technical point of view. A fully integrated euro area money market - an essential prerequisite for a monetary union - was reality from the very first day of the introduction of the euro. The overnight interest rate, a key indicator of the monetary policy stance, has been practically the same across the countries in the euro area since the start of Stage Three of EMU in January 1999. This was certainly not obvious ex ante. It required a substantial amount of preparatory work, not only by the central banks in the euro area, but also by other economic agents, most notably the banking sector and the governments.

The main yardstick for any evaluation of the success of the euro is, of course, the maintenance of price stability in the euro area. This is the ECB's primary objective under the Treaty. The monetary policy strategy of the ECB was designed in such a way as to ensure the fulfilment of this objective. As a first element of the strategy, the Governing Council of the ECB defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". This definition serves to anchor inflation expectations and provides a framework against which the ECB can be held accountable. Short-term fluctuations in the inflation rate are not under the control of the central banks. Therefore, it was also announced that price stability is to be maintained over the medium term, imparting a medium-term orientation to the strategy as a whole. In order to attain the so-defined objective, the ECB is pursuing what is known as a two-pillar approach. The first pillar is a prominent role for money. The second is a broadly based assessment of the outlook for price developments and risks to price stability. Giving money a prominent role in monetary policy analysis is something quite natural for a central bank geared towards price stability. Inflation is ultimately a monetary phenomenon. The prominent role for money is signalled by the announcement of a

reference value for the annual rate of growth of the broad monetary aggregate M3. In December 2000, the Governing Council of the ECB reconfirmed the reference value of 4 1/2% annual growth. While the reference value plays an important role in monetary analysis, the assessment of the first pillar goes beyond the evaluation of deviations of M3 growth from the reference value. It encompasses a variety of approaches which assign a central role to money, as well as a detailed analysis of the components and counterparts of M3.

Monetary data on their own do not constitute a complete summary of all the information on the economy required to set an appropriate monetary policy for the maintenance of price stability. Therefore, in parallel with the careful analysis of monetary variables, a broadly based assessment of the outlook for price developments and of the various risks to price stability in the euro area plays a major role in the ECB's strategy. This assessment is made on the basis of a wide range of variables influencing future price developments. This range includes, inter alia, the exchange rate, wages, unit labour costs, bond prices, the yield curve, fiscal policy indicators, various measures of real economic activity, price and cost indices. In addition to an in-depth analysis of the individual indicators, macroeconomic projections for real GDP growth and inflation are regularly made. While such projections facilitate the structuring and summarising of some of the individual factors, they can only provide a partial summary of the state of the economy. Hence they are only one element of the second pillar. Overall, the two-pillar approach has proven to be successful in the first just over two years of Stage Three, which were characterised by an above-average degree of uncertainty. The ECB's strategy is certainly rather complex, but - at the same time - it has the crucial advantage of guaranteeing that no piece of relevant information is left out in the policy analysis.

Regarding actual price developments, we have to admit that, after very moderate inflation in 1999, HICP inflation has been standing above 2% since June 2000. However, this is due mainly to direct effects stemming from the external oil price shock. Such a shock cannot be prevented by monetary policy. It is very positive under these circumstances that the public's trust in the ability and willingness of the ECB to maintain price stability has never faded. This is signalled, for instance, by the low and stable inflation expectations implicit in long-term interest rates. A high level of anti-inflationary credibility has been obtained in no easy times, which were characterised by an increase in headline inflation in the euro area in 2000 due to the oil price shock and the protracted depreciation of the euro. This is important, especially in view of how oil price shocks in the not too distant past have sparked long periods of higher inflation in Europe. In the long run, of course, there is no substitute for a track record of price stability to bolster monetary policy credibility. This is what the ECB has been and will be consistently aiming for. From this perspective, it is clearly too early to come to an assessment after only two years of experience.

The outlook for the euro area economy remains positive at the current stage. Real GDP growth was relatively strong in 2000. However, output growth was lower in the second half of last year than in the first. At the same time, the overall level of confidence in the euro area has remained high. Economic indicators relating to developments around the turn of the year support the view that economic growth will remain fairly robust. The high overall rate of capacity utilisation, continuing employment creation and lower unemployment should contribute to supporting investment and consumption. Looking ahead, for this year and 2002, we continue to expect that positive fundamental factors such as favourable real disposable income developments and long-term financing costs will underpin growth in domestic demand. At this juncture, there are no signs that the slowdown in the US economy is having significant and lasting spillover effects on the euro area. Nevertheless, the deterioration of the external environment of the euro area constitutes an element of uncertainty, against the background of which growth prospects in the euro area should be carefully monitored. As regards the medium-term outlook for price stability, risks appear to be more balanced than in late 2000, mainly due to the moderation of monetary growth.

The credibility of the ECB has also been fostered by the sound institutional setting envisaged in the Treaty, as I have just hinted at some minutes ago. In particular, the clear assignment to the ECB of the task of safeguarding price stability and its independence are important in this respect. This is facilitated by the fiscal discipline brought about by the Stability and Growth Pact and by the "no bailout" clause in the Treaty. The Stability and Growth Pact requires government budgets to be close to balance or in surplus in normal circumstance. The soundness of fiscal and monetary policies represent the cornerstone of an institutional setting which should foster non-inflationary growth in Europe in the future. It is important to recall that the design of this setting took stock of decades of historical experience and of academic research; in short, it took advantage of a long, cumulative process of learning.

The euro has become one of the two most important currencies in the global economy in a short period of time, as is signalled, for example, by the massive issuance of euro-denominated bonds worldwide. This position has been facilitated by the economic weight of the euro area in the global context. Some commentators have pointed out that the international role of the euro accrues to the ECB's mission and gives it a compelling "global" responsibility. Let me stress that, while the use of the euro as an international currency is likely to increase, the Eurosystem (i.e. the ECB and the twelve national central banks of the euro area) has adopted a neutral stance in this respect. We will neither hinder nor actively promote the international role of the euro, but leave its development to market forces. However, by gearing its policy towards the maintenance of price stability in the euro area, the Eurosystem provides a sound basis for the euro's external value in the medium-term and thereby indirectly fosters the euro's international role.

Within the euro area, the euro is certainly acting as a catalyst to promote the integration of product and capital markets. There is evidence, for instance, that the introduction of the euro has led to a strong increase in corporate euro-denominated bond issues, a segment of the market where Europe was and is still significantly lagging behind the United States. There is also evidence of an acceleration of the process of restructuring the banking sector in some euro area countries, although really pan-European mergers and acquisitions have hardly taken place. Finally, some evidence also points to a reduced "home bias" in investors' portfolios since the start of Stage Three of EMU. This would be a signal that the creation of a truly area-wide financial market is on its way.

Despite all these successes, there is of course no reason to be complacent. Quite the contrary, a lot remains to be done and the right attitude is to roll up our sleeves and go on working. The ECB and the national central banks of the Eurosystem face many challenges ahead in their efforts to ensure that the euro will be a lasting success. Let me now deal with some of these challenges.

At the current stage, the most obvious and immediate challenge on our agenda is obviously the cash changeover, an enterprise of historic relevance that will change the life of 300 million Europeans in a lasting manner. You will certainly know that after E-day (1 January 2002) the euro and the legacy currencies will circulate in parallel for at most two months. The euro will become the only legal tender in the twelve participating Member States. The ECB and the national central banks are actively engaged on two fronts, the production of the banknotes and the information campaign (the "Euro 2002 Information Campaign"). The introduction of the euro banknotes and coins is an unprecedented logistical challenge for all the parties involved, since around 15 billion banknotes and 50 billion coins have to be produced. In order to support a smooth distribution of banknotes and coins, the ECB has set up procedures for the frontloading and sub-frontloading of euro banknotes and coins inside the euro area as from 1 September 2001. We are all well aware of the fact that there will also be a considerable demand for euro banknotes by non-euro area residents. Therefore, the Governing Council also decided on some general principles for the distribution of frontloaded euro banknotes outside the euro area.

The "Euro 2002 Information campaign" is aimed at familiarising the general public with the new currency and at making sure that the euro banknotes and coins are well received by euro area residents. The message of our campaign concentrates on four main issues, namely the detailed visual appearance of the banknotes and coins, the main security features (which will be unveiled in September 2001), the denominations of the euro banknotes and coins, and the changeover modalities. Let me assure you that we are taking the introduction of the euro banknotes and coins very seriously. We are well aware that, in one year's time, the public at large will tend to identify the euro and the ECB through the uniform image of the euro banknotes. Therefore, next year is of paramount importance for the public image of the ECB as an organisation.

It should be stressed that the responsibility for the cash changeover does not fall exclusively on the euro area central banks. Other parties (banks, firms, governments) are also involved in the changeover. Actually, the Member States have the ultimate responsibility for the changeover, with the European Commission and the Eurogroup monitoring the whole process. This decentralised approach is reasonable because it assigns clear responsibilities, favouring an efficient division of labour and fostering the accountability of all the parties involved.

Looking beyond the immediate future, there are still other challenges. For the ECB, maintaining price stability is a permanent challenge. Building up a positive track record in this respect will be essential for its medium-term credibility. Of course, other policy-makers also face a number of challenges. In particular, it was decided at the Lisbon meeting of the European Council that all possible actions should be taken in order to make the European economy the most advanced knowledge-based

economy of the world by 2010. The ECB shares the view that this should be the most important ultimate objective of policy-makers in Europe. Enlarging Europe's growth potential is the main yardstick for evaluating the pros and cons of different policies. At the same time, the ECB is convinced - and I think for very good reasons - that the best contribution that monetary policy can make to sustaining non-inflationary long-term growth is to maintain price stability in the euro area.

Europe's main problems are not of a cyclical nature; its main problem is, in fact, the high level of structural unemployment. In the first two years of Monetary Union, the euro area countries have found themselves in the best economic situation they have had since at least a decade, with robust output and employment growth, low inflation and no major economic imbalances. What is needed now is the enhancement of the growth potential of the economy over the medium term. The main task remaining on the governments' agendas is therefore to promote the structural reforms that are essential to increase the flexibility and competitiveness of the European economies, and to make them more permeable to the introduction of new technologies and business practices.

The area of labour markets is particularly important if the unemployment rate is to be lowered in a lasting manner. A well functioning labour market should always ensure that general wage increases are compatible with the objective of price stability (what I would define as "macro"-efficiency) and bring about flexibility and an optimal allocation of resources (what I would label "micro"-efficiency). I will concede that all these matters are not, strictly speaking, related to the euro; they would, very plausibly, have been on the agenda of European governments anyway. The euro, however, makes them more compelling, forcing European governments to speak to one another even more frequently and together to find creative solutions as soon as possible.

Efforts to bring about further integration in the product and capital markets by harmonising regulation across Europe are also very important. They contribute to making Europe really "one market" and to providing further economies of scale.

Fiscal developments are monitored very closely by the ECB. We have noted that a number of governments need to reinforce their efforts to proceed along the path of fiscal consolidation in order to achieve the objectives of the Stability and Growth Pact. By increasing the level of ambition of their stability programmes, especially in respect of expenditure restraint, they would free resources for productive investment and reassure the public with regard to future tax developments, thereby fostering economic growth.

I have already expressed the view that the ECB's best contribution to economic welfare in Europe is to maintain price stability in the euro area. The ECB will continue to address governments and other policy-makers, convinced as we are that monetary policy does not act in a vacuum and that the task of maintaining price stability is much easier in a flexible and competitive economy. In this regard, we have taken note that, while some countries have implemented structural reforms, much remains to be done if the objectives set at the Lisbon meeting are to be attained.

One area where further progress is needed is the integration of the equity and securities markets. There is still a certain degree of fragmentation in Europe's financial markets. The Eurosystem is directly involved in the area of securities and settlement systems, because of the repercussions these may have on the conduct of the common monetary policy. The Eurosystem is also active in ensuring that retail payments systems are harmonised across Europe. At the moment, cross-border retail payments cost more and take longer than payments effected within countries; this is incompatible with a well-functioning monetary union. All these aspects represent important challenges for the Eurosystem and the financial sector at large.

In conclusion, I hope that my presentation of the challenges the ECB and other European policy-makers are facing has not distracted you from the assessment in the first part of my talk. It is perhaps useful to restate my main findings. The introduction of the euro has been a notable success, and I am sure that the euro will contribute to raising economic growth in Europe in a lasting manner.