

## **Willem F Duisenberg: European Economic and Monetary Union: a success story**

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the annual conference of the Ifo Institute, Munich, 26 June 2001.

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Ladies and gentlemen,

It is a great honour for me to be invited to the annual conference of the Ifo Institute in Munich. The Ifo Institute is among the most renowned economic research institutes in Germany. In addition to participating in the production of the joint spring and autumn reports by German economic research institutes, it also plays a major role for the financial markets in compiling economic analyses, particularly on account of its Ifo Business Climate Index. Moreover, the Ifo Institute, through its academic research on a number of current economic policy issues, makes a valuable contribution to discussions on economic policies.

### **1. Introduction**

"European Economic and Monetary Union: a success story" - many of you might ask whether an assessment of this can be made at such an early stage. I know that in Germany in particular, many citizens view the changeover from the Deutsche Mark to the euro banknotes and coins with much scepticism. In my opinion, it is more a question of the loss of something which is well-established, i.e. the Deutsche Mark, than of any real concerns about the new currency. This sort of reaction is very human. Nevertheless, holding onto something which is well-established can hinder progress and change which in themselves can bring many advantages. The participants in European Economic and Monetary Union (EMU) have already come a long way and have overcome a number of difficulties. The cash changeover simply completes this process, which began at the beginning of 1999 with the start of Stage Three of EMU. It was mainly on account of technical reasons that the euro banknotes and coins could not be introduced simultaneously at the start of Stage Three of EMU at the beginning of 1999. Despite this, the national currencies of the Member States of EMU have only been representing denominations of euro since then. The euro is therefore already "OUR money".

I should like to refer briefly to the period before the introduction of the single currency at the beginning of 1999. Of course, we should not talk only of the past. The monetary policy of the European Central Bank (ECB) is after all forward-looking and thus I shall take a forward-looking stance myself. Following a brief review of the history of EMU, I should like to explain the ECB's assessment of the monetary and economic situation. In accordance with the ECB's strategy, I shall use the two-pillar strategy as the basis for my explanations and analyse potential risks to price stability. In this respect, I should like to elaborate on one of the most important issues this year and next year and that is the cash changeover.

### **2. Milestones on the path towards European Economic and Monetary Union**

The major plan to establish European Economic and Monetary Union was conceived over thirty years ago. In 1970 the so-called Werner plan was drawn up under the chairmanship of the former Luxembourg Prime Minister, Pierre Werner. It was only in the mid-1980s, however, that the idea of European Economic and Monetary Union found sufficient political support and was able to gradually make further concrete progress in the following years. The Single European Act of 1986 is a milestone on the path towards a single European market. The latter is characterised by the free movement of goods, services, labour and capital. At the end of the 1980s, the Delors report, which was drawn up under the chairmanship of the then President of the European Commission, Jacques Delors, laid the foundations for the introduction of a single currency. In this respect, a three stage process was envisaged together with the establishment of a European Central Bank with the primary objective of maintaining price stability. The first stage of EMU began on 1 July 1990 with the free movement of capital between most of the Member States. This marked an important step towards the efficient allocation of capital within the European Union. However, the exchange rate risk remained an important determining factor in the decisions of investors.

When looking back over the process towards a single European currency, the difficulties and temporary setbacks should not be forgotten, including, in particular, the EMS crisis in the autumn of 1992. Less than a year later, following renewed volatility in the EMS, the fluctuation margins for the bilateral EMS central rates were widened to +/- 15% in order to put a stop to financial market speculation. Both of these events can be regarded as examples of a number of tests by the financial markets to see how serious the Member States really were on the issue of integration.

In November 1993, the Maastricht Treaty came into effect following the ratification by the Member States. The Treaty laid down the convergence criteria which were a prerequisite for joining EMU. On 1 January 1994, at the beginning of Stage Two of EMU, the European Monetary Institute (EMI) was established. The latter was given the task, as the forerunner of the European Central Bank, of preparing the framework in which the ECB, within the European System of Central Banks (ESCB), was to assume responsibility for monetary policy at the start of Stage Three of EMU on 1 January 1999. The period prior to the start of Stage Three of EMU was characterised by the unprecedented convergence of short and long-term interest rates, the convergence of inflation rates, the reduction in the general government budget deficits and debt ratios as well as relatively stable exchange rates between the countries joining EMU.

Given the convergence of long-term interest rates towards a relatively low level, market participants gave the ECB a vote of confidence at the start of Stage Three of EMU. Moreover, inflationary expectations have remained low since the beginning of Stage Three of EMU. I shall elaborate on this issue later on in my speech. This shows that the ECB has achieved high credibility in terms of its primary objective of maintaining price stability. I should now like to explain the economic and monetary developments in the euro area and the outlook for price stability in the context of the two-pillar strategy.

### **3. The first pillar of the ECB's strategy - monetary developments give grounds for a favourable outlook for price stability**

As you know, the ECB assigns a prominent role to monetary developments in the euro area within the context of its monetary policy strategy. Empirical evidence of monetary developments in the euro area points towards a stable relationship between demand for the broad monetary aggregate M3 and price developments as well as towards good leading indicator properties of M3 growth for inflation over the medium term.

The ECB does not pursue monetary targeting, instead, it has set a reference value for the growth of the broad monetary aggregate M3 for a variety of reasons. This reference value is derived on the basis of the Eurosystem's definition of price stability, i.e. an increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% compared with the previous year and assumptions for trend potential output growth of between 2% and 2 1/2% as well as for a trend decline in velocity of M3 of between 1/2% and 1% per annum.

The reference value for M3 constitutes the anchor for the analysis and communication of monetary developments in the euro area. The monetary analysis is, however, not restricted to a comparison of the current growth in M3 with the reference value, rather it incorporates a much broader approach. Because, in order to be able to interpret monetary developments accurately, it is crucial to know the precise reasons for these developments. This means that, in addition to the broad monetary aggregate M3, the individual components of M3 and the counterparts to money, in particular the dynamics of loans to the private sector, must be analysed in respect of their implications for future price developments. Allow me to briefly explain why a detailed analysis of the forces behind monetary developments is so important.

Not every increase in M3 growth in excess of potential growth has an effect on consumption and hence, necessarily poses a threat to price stability. Greater dynamics in monetary developments can, particularly in the short term, be attributable to portfolio movements for example, which are temporary and therefore tend not to be a problem for inflationary developments. This was probably the case in the first few months of 2001 when the uncertainty on the stock markets temporarily increased the attractiveness of short-term secure assets. The aim of the analysis must, therefore, be to trace the growth in M3 back to its underlying factors in order to assess the extent to which some components of the monetary developments are not relevant for future domestic price developments.

The revisions to M3, which the ECB made in its publication of monetary data for April, should also be considered in this light. The ECB has recently come into the position to indicate the extent to which

money market fund shares/units are held by non-euro area residents and to exclude these shares/units from M3. All national central banks (NCBs) in the euro area now regularly report data on the money market fund share/unit holdings of non-euro area residents in accordance with the general reporting obligations in the context of money and banking statistics. From a conceptual point of view, M3 should only capture the money holdings of households and firms located in the euro area. Above all, these have close links with domestic private consumption and to domestic price developments. The money holdings by non-residents are, by contrast, likely to be used more for portfolio purposes. These revisions should bring back the monetary aggregate M3 closer to its theoretical concept, thereby tending to strengthen the information content of M3 for domestic price developments. Purchases of money market fund shares/units by non-euro area residents increased following the start of Stage Three of EMU, whereas previously they had been of very little importance. The demand for short-term, high-quality instruments was likely stimulated, on the one hand, by structural factors such as, fiscal consolidation in most of the industrial countries and the resulting decline in the issuance of government debt securities, and on the other, by economic factors such as the flattening of the yield curve.

One further correction to the M3 statistics still needs to be made. To date, only provisional data are available on purchases of money market paper and of short-term debt securities by non-euro area residents. By the end of the year, revised M3 figures should be published taking full account of negotiable instruments held by non-euro area residents.

One of the important general challenges of producing and interpreting statistics is to maximise their economic content. The revision of the monetary statistics in order to take into account purchases of negotiable instruments by non-euro area residents is a further step in this direction. The monetary statistics are among the most advanced statistics available for the euro area. They are based on a fully harmonised consolidated balance sheet and on fully harmonised money-issuing and money-holding sectors, as well as on harmonised financial instruments. In view of their close links with inflationary developments and their good leading indicator properties for future inflation, monetary developments must also play a prominent role in the monetary policy strategy of the ECB in the future.

Since the second quarter of 2000, growth in M3 has been declining mainly on account of the increase in the short-term interest rates. Adjusted for the money market fund shares/units held by non-euro area residents, M3 grew at an annual rate of around 41/2% in the first four months of 2001. If current data on purchases of money market paper and short-term debt securities of non-euro area residents are also taken into account, the annual rate of growth of M3 over recent months has probably been slightly below the reference value for M3. Overall, monetary developments therefore point towards a favourable outlook for the medium-term maintenance of price stability.

Growth of credit to the private sector in the euro area has increased relatively strongly since the start of Stage Three of EMU. In particular in 2000, some of the credit demand can, however, be attributed to the financing needs in the context of mergers and acquisitions, partly outside the euro area, and to the financing of UMTS licences. These factors, however, are not likely to affect domestic price developments. In this respect, the dynamics of loans to the private sector in the euro area also support the outlook of monetary developments for future price developments.

#### **4. The second pillar of the ECB strategy - real GDP growth around the level of trend potential growth**

I should now like to talk about the real economic situation. The analysis under the second pillar of the ECB's monetary strategy also confirms that the current level of key interest rates remains appropriate to ensure that the euro area economy will be able to maintain price stability in the medium term.

Macroeconomic projections of developments in the euro area have just recently been published in the June Monthly Bulletin by the experts of the Eurosystem. As announced last year and conducted in December 2000 for the first time, these projections are produced twice a year by the experts from the national central banks of the euro area Member States in collaboration with the experts from the ECB. They serve as input for the assessment of economic developments and of the risks to price stability conducted by the Governing Council of the ECB within the framework of the second pillar of the monetary policy strategy of the ECB.

When interpreting these projections, it should always be taken into account that they are based on a set of technical assumptions and that therefore they are not "unconditional". The projections are produced, for example, on the basis of unchanged short-term interest rates and unchanged bilateral

euro exchange rates. The projections by Eurosystem experts are therefore "conditional" and not directly comparable with the "unconditional" projections published by other institutions such as the European Commission, the IMF and the OECD, for example. Moreover, the projections are published in the form of ranges, in order to take account of the degree of uncertainty. The ranges reflect the average forecast error from previous periods and therefore differ between each of the projected variables and the projection horizon.

Compared with December 2000, growth expectations for 2000 and 2001 have been reduced. It is probable that in 2001 real GDP growth in the euro area will decline as compared with the strong increase observed in 2000, before recovering slightly in 2002. Overall, this year and next year it will broadly be in line with trend potential growth for the euro area. At the same time, HICP inflation will probably be somewhat higher in 2000 than was expected at the end of last year. The expectation that inflation will fall in 2001 and will remain below 2% in 2002, has, however, remained unchanged, meaning that the ECB will meet its objective of maintaining price stability in the medium term.

I should now like to go into some detail on the prospects for growth in the euro area. Eurostats first estimate of the growth of real GDP in the first quarter of 2001 has confirmed that economic growth in the euro area has moderated since the second half of 2000. Moreover, industrial production declined further in April. The sentiment indicators available for the euro area also confirm weaker economic growth. The surveys provided to assess the situation and prospects for the economy constitute a valuable source of information for an up-to-date economic analysis. You also make a valuable contribution towards an up-to-date assessment of economic developments in Germany with the production of your Ifo Business Climate Index. In this context, it should be emphasised that the Governing Council of the ECB adopts an area-wide perspective in its assessment of economic conditions and the outlook for price stability.

It is likely that during the course of the year the decline in global economic growth will show up to a somewhat larger extent than has been the case up until now in net export developments. While global trade (excluding the euro area) increased last year by around 12%, it will probably only rise by just under 6% this year according to the Eurosystem's projections. This will have a negative impact on export prospects for the euro area. While growth in export (including intra-trade) rose at double-digit rates last year, growth rates for the current year, on the basis of an unchanged euro exchange rate, are expected to lie somewhere between 5% and just under 8%. The contribution of net exports to GDP growth should, therefore, decline considerably compared with the previous year and be largely neutral in the current year.

As illustrated by economic growth in the euro area in the first quarter of 2001, subdued export prospects can put pressure on domestic demand and particularly on investment. Despite these negative factors one should not, however, forget the positive factors which contribute towards a stabilisation of domestic demand. These factors include the still favourable financing conditions for investment and consumption and a slight further increase in employment in the euro area. Furthermore, there are no fundamental economic imbalances, particularly in respect of the personal savings ratio, which could put pressure on consumption in the euro area.

Against this background, consumer confidence in the euro area has been relatively robust over recent months. Despite the slightly weaker assessment of the general economic situation in the latest survey in May, consumer confidence in the euro area is still at an historically high level. In this respect, these positive factors should make a valuable contribution towards ensuring that growth remains broadly in line with its potential.

I should now like to elaborate on price developments this year and next year. Following an average annual HICP inflation rate of 2.3% in the euro area last year, temporary pressures are likely to cause inflation to be above 2% for a longer period of time than was expected at the end of 2000 by all institutions. Strain factors and easing factors are battling against each other at the same time. The heavy impact of energy price developments should ease considerably this year. For the time being at least, the renewed increase in energy prices in the second quarter of the year has delayed the fall in the inflation rate in the euro area. In addition, the increase in food prices as a result of BSE and the outbreak of foot-and-mouth disease in some of the Member States have had an impact on developments in the HICP. Furthermore, the increase in some of the administered prices and indirect taxation in some of the countries of the euro area have caused the inflation rate to rise over the past few months. These factors should, however, only have a temporary effect on inflation in the euro area. Lower economic growth also seems to point to a decline in the pressure on the price level.

In spite of the fact that these factors will only have a temporary effect on price developments, caution is warranted. Above all, it is important that an inflation rate of over 2% over a long period of time does not lead to higher wage demands. Until now, wage developments in the euro area have been relatively moderate. Important wage negotiations will, however, take place in the second half of 2001 and in 2002. Further developments in wages will therefore be closely monitored by the ECB. Hence, we will continue to remain vigilant.

Despite the long period of time in which inflation has stood above 2%, inflation expectations have so far hardly changed in the euro area. The difference between the nominal French government bond yields and the corresponding real yields on French index-linked government bonds can be used as an approximation for measuring inflationary expectations. This so-called break-even inflation rate has remained below 2% for ten-year government bonds since the start of Stage Three of EMU and currently stands at around the average level seen in 2000. This implies that the financial markets are convinced that the ECB will be able to keep inflation in the euro area below 2% in the medium term. This is a success for monetary policy, particularly during such difficult times in which external economic influences and further temporary factors are having a transitory impact on HICP inflation. The relatively low long-term interest rates arising from low inflation rate expectations and hence favourable financing conditions are the most valuable contribution which monetary policy can possibly make to achieving sustainable and sound growth prospects in the euro area.

In addition to monetary policy and the responsible behaviour on the part of the social partners, fiscal policy is also responsible for ensuring sound long-term growth. In order to achieve this, fiscal policy must continue the process of consolidation as laid down in the Stability and Growth Pact and in the national stability programmes. At the same time, fiscal policy must create an attractive economic environment for business investment and for the supply and demand of labour. In this respect, most national governments of the euro area have already taken steps in the right direction. Lower tax rates on businesses and households is, in this respect, very welcome. However, this reduction in the tax rates requires the appropriate adjustments to be made in order to meet the objectives of fiscal consolidation, for example with the expansion of tax bases or cuts on the expenditure side. Until now this has not taken place to a sufficient extent. The reduction in the expenditure ratios over the past few years in the euro area has, above all, been achieved through lower interest payments and lower expenditure on unemployment benefits in the course of the strong expansion of the economy. Structural spending cuts must be more ambitious in order to meet the objective of sustainable fiscal consolidation.

The budget deficit in the euro area will probably rise slightly in 2001, excluding the proceeds from the sales of UMTS licences last year. This would mean that some of the euro area Member States may not be able to meet their fiscal consolidation objectives for the current year, despite the fact that economic growth in the euro area will probably be broadly in line with its potential. In order to achieve a sound and sustainable fiscal position, however, the euro area Member States are required to continue their fiscal consolidation efforts as laid down in the medium-term fiscal plans in accordance with the Stability and Growth Pact.

Other areas in which more effort needs to be made by the national governments, in particular in the large euro area Member States, include the goods and labour markets. Also in these areas, the first steps in the right direction have been taken. The deregulation of the goods markets must, however, be expedited in order to increase competition and to strengthen the growth of the economy. This is the only way to increase the long-term growth potential in the euro area. With regard to labour markets, unemployment has fallen considerably over the past few years to stand at 8.3% in April 2001. The number of unemployed has declined by more than one million compared with April of last year, even though, most recently, the decline in unemployment has actually decreased slightly in seasonally adjusted terms. An unemployment figure of 8.3% is, however, much too high. Further incentives need to be made in respect of the demand for and the taking-up of employment. This requires not only further reforms to the tax systems, but in particular also to the social security systems.

## **5. The implications of the euro cash changeover**

Finally, I should like to talk about an issue which, until the beginning of next year, will be the focal point: the euro cash changeover. By 1 January 2002, 14.25 billion euro banknotes and 50 billion coins will be produced for the 12 Member States of the euro area. The introduction of the banknotes and coins is an enormous logistical challenge. As you know, the ECB has, therefore, decided that the frontloading of euro banknotes and coins to credit institutions in the euro area and the sub-frontloading

of euro banknotes and coins by credit institutions under special conditions to professional cash users can begin on 1 September this year.

Owing to its monetary nature, the euro cash changeover does not only present a logistical challenge, but also affects the economic analysis within the framework of the monetary policy strategy of the ECB.

A visible sign of the potential impact of the cash changeover on monetary developments is the annual rate of growth of currency in circulation which has been negative since the end of last year to stand at -2.9% in April. Preparations by euro-area residents for the cash changeover could be a factor in these developments. It is possible that this factor will become even more important during the course of the year, when a growing number of the population pays in its liquid reserves to the banks, which are not directly needed as cash on hand. The effect of these transactions on overall developments in M3 should, however, be relatively minor, as a large part of the liquid reserves, which is held as cash on hand, should be invested in deposits which are also included in M3. If this is the case, M3 growth should largely remain unaffected.

Not only the citizens of the euro area, but also non-euro area residents with cash holdings in the current national currencies of the euro area countries will prepare themselves for the cash changeover. In particular, this affects inhabitants from central and eastern Europe using Deutsche Mark banknotes in parallel with their respective national currencies. According to estimates made by the Deutsche Bundesbank, Deutsche Mark holdings abroad in the mid-1990s accounted for around 30% to 40% of the German currency in circulation (see Franz Seitz: The circulation of the Deutsche Mark abroad, Discussion Paper 1/95, Deutsche Bundesbank, May 1995). That is equivalent to around EUR 45 billion, which could potentially flow back into the euro area, presuming that the amount has remained unchanged since then.

According to all available sources, the actual flowback of cash holdings from abroad should, however, be a lot lower. Owing to its geographical proximity and the close trade links with central and eastern Europe, the Deutsche Mark is used in many countries not only as a store of value but also as a transaction currency. Therefore, it is unlikely that the demand for the Deutsche Mark will be completely replaced by a demand for other non-euro area currencies. In addition to this, the exchange of national currencies of the euro area for euro will equally be possible outside of the euro area and it will probably also be used to a large extent by the population. It is difficult to speculate over the behaviour of the informal side of the economy. At the same time, however, it should not be forgotten that we are talking about a relatively small part of the economy, even though this part of the economy uses cash to a relatively large extent. In addition, empirical findings have, to date, given no hard evidence of any significant flowback of Deutsche Mark banknotes from abroad. In the light of this, it is unlikely that there will be any major effects on the growth of M3 or any significant impact on the exchange rate of the euro as a result of the euro cash changeover.

In addition, the ECB will also closely monitor the potential price risks relating to the euro cash changeover. In principle, it cannot be ruled out that businesses will try to use the changeover to the euro in order to introduce price increases. This would temporarily affect inflationary developments in the euro area. In this respect, the use of the dual price display method for a while will be of benefit for the consumers, as it will allow them to make a direct comparison between the prices in their respective national denomination of the euro with the euro. Against this background, the ECB appeals to the consumers to be vigilant in respect of possible price increases as a result of the euro cash changeover.

It should not be forgotten, however, that the conversion of prices in the former national currencies of the euro area into euro can sometimes lead to favourable rounding effects from the point of view of psychological price setting. In addition, hard competition in the retail sector will not make it possible for price increases to be introduced easily. Comparisons with similar conversions in the past, such as the introduction of the decimal system in the United Kingdom at the beginning of the 1970s or the abolition of the cent in the Netherlands in 1983 show, above all, that the effect on price levels was generally negligible. Finally, many euro area Member States have intensified the monitoring of prices. Their governments have also guaranteed that overall, the general government will, in the context of the euro conversion, waive any receipts arising from any fees and charges levied by it and convert prices in a neutral manner or smoothed in favour of the consumer. Overall, possible short-term price and cost burdens should, therefore, be seen against longer-term favourable price effects as a result of lower transaction costs and greater price transparency in the euro area. Without a doubt, however, price developments relating to the euro cash changeover will need to be closely monitored over the coming

months by all participants, including the general government and consumers and last but not least the ECB.

## **6. Conclusion**

You can be certain that by maintaining price stability in the euro area, monetary policy will continue to do its very best to contribute towards creating an attractive location, ensuring sound economic growth and prosperity for the population. I am confident that if fiscal policy and the social partners also make their contribution, the longer-term prospects for the euro area will be favourable and the euro area will become an increasingly attractive and dynamic location. I have no doubts that under such circumstances the success of EMU in the past shall continue into the future. I say this in view also of the enlargement of the European Union towards central and eastern Europe. Major reforms in the EU are needed in order to achieve further integration. The fact that further European integration constitutes a very positive growth potential by enhancing competition and as the result of the interplay of forces should not, however, be overlooked. I should like to refer back to my opening lines: holding onto something which is well-established can hinder progress and change which in themselves can bring many advantages. This applies not only to the introduction of the euro but also to the enlargement of the European Union.

Ladies and gentlemen, thank you for your attention.