Jean-Claude Trichet: The Euro - a major structural reform of the European economy

Speech by Mr Jean-Claude Trichet, Governor of the Banque de France, at the NIKKEI Euro Symposium, London, 5 November 2001.

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Ladies and gentlemen, it is a great pleasure and an honour for me to be speaking here today, at the Nikkei Euro Symposium, in front of such a distinguished audience. I am particularly pleased to express my views on the euro and its prospects following the launch of the notes and coins, which will be a reality within 8 weeks

The economic and financial ties between Europe and Japan have been strengthened significantly over the recent period : European investors and companies have stepped up their market presence in Japan these last two years ; likewise, Japanese foreign direct investments in the Euro area and Japanese portfolio investments in euro since January 1999 have highlighted the confidence in the European single currency.

I would like to explain why the euro and Monetary Union have been successful from the outset, and the conditions and prospects for building on this achievement. I will then discuss the historical event of the introduction of banknotes and coins at the end of this year.

I. The euro and Monetary union are based on a credible monetary policy, and contribute to an APPROPRIATE economic and monetary equilibrium in Europe

1. The euro is based on a credible, stability-oriented monetary policy

a) I would like to point out that, **from a technical point of view**, the launch of the euro on financial markets, on 1 January 1999, has been an indisputable success, and that the Eurosystem, made up of the ECB and the National Central Banks of the euro area, has fully achieved the objectives assigned to it in the following areas:

- **operational efficiency**, highlighted by the precise adjustment of banking liquidity and effective steering of short-term interest rates;
- the **security** provided by the procedures and systems implemented, both for the execution of interbank transactions, and vis-à-vis large-value payments. The inter-bank market became integrated in early January 1999, right from the start of Monetary Union, thanks to the setting up of the Target system for the real-time transfer of large-value payments throughout the euro area and in other EU countries.
- and, finally, the smooth functioning of the **Eurosystem**, which is an integrated organisation in which the decision-making centre works in constant contact with the national central banks on the implementation of operations.

b) Together with many other factors, this technical and operational success has contributed to the high level of **credibility of the single monetary policy** which is based, in particular, on the independence of the European Central Bank and national central banks, and on the store of confidence inherited from the latter.

Moreover, contrary to popular belief, European Monetary Union did not start from scratch. For no less than 12 years before the launch of the euro, six of the twelve currencies which now make up the euro – and represent almost two thirds of euro-area GDP - had proven remarkably stable, and were not realigned within the ERM.

This high degree of confidence also stems from the acknowledged efficiency of the operational set-up of the Eurosystem, which is based on the principle of decentralisation stipulated in the Treaty. The Eurosystem is a team. The European monetary team now comprises the ECB and the national central banks of twelve Member States, following the

Bank of Greece’s entry on 1 January 2001. All the members of the Eurosystem work in close co-operation.

c) The credibility of the Eurosystem lies, fundamentally, in its **stability-oriented monetary policy strategy**.

The Maastricht Treaty has given us a mandate for maintaining price stability. We have decided to be as clear and as transparent as possible by providing a clear definition of price stability: that is to say a year-on-year *increase* in the overall Harmonised Index of Consumer Prices (HICP) of the euro area of *below 2%*.

The aim of the single monetary policy is to ensure medium-term price stability, therefore creating a favourable monetary and financial environment for economic growth. Price stability offers an anchor for wage negotiators, and is a necessary factor for competitiveness, which is in turn essential for achieving balanced and therefore sustainable economic growth.

The euro area is however a complex financial and economic zone. For this reason, we have adopted a broader-based approach, taking into account all relevant data. We have thus based our monetary policy on two “pillars”.

In view of the monetary origins of inflation in the medium term, we have assigned a key role to the monetary aggregate M3, which constitutes the first “pillar” of our monetary policy strategy. This pillar is based on a *reference value* which we set at 4.5% for the annual growth rate of the broad monetary aggregate M3. This monetary indicator is regarded as being the most compatible with medium-term price stability. Last December, we confirmed this 4.5% growth rate for M3. The concept of a *reference value* does not imply a commitment on the part of the Eurosystem to automatically correct deviations in monetary growth in the short term. The reference value of M3 is consistent with lasting price stability. Naturally, we also follow the counterparts of M3 closely, that is to say the sources of money creation, and especially lending to the economy and capital flows with the rest of the world.

However, trends in monetary aggregates are not in themselves sufficient for assessing the risks to price stability. This is why we need an exhaustive description of the prevailing economic and financial situation. The second pillar of the monetary policy strategy is based on a broad range of variables acting as leading indicators of the outlook for euro area price developments.

Our monetary strategy ensures a **continuity** from the monetary policies previously conducted by the national central banks, which now belong to the Eurosystem. This strategy has been well received by financial markets and the general public. In particular, the relatively low yields on long-term euro-denominated bonds confirm that the Eurosystem has retained the credibility store it inherited.

d) Lastly, the credibility of the euro also results from the Eurosystem's constant efforts in terms of **transparency** and communication. I must stress here that the Eurosystem is one of the most transparent central banks in the world. Once a month, *immediately* after the ECB Governing Council meeting, the President of the ECB holds a press conference which starts with a precise report of the assessment of the Governing Council, and which is made available in real time on the ECB website.

The Eurosystem was the first central bank in the world to introduce, on 1 January 1999, the concept of regular, frequent, real-time communication in the domain of monetary policy. Other major central banks have since decided to follow us.

Being accountable, for an independent institution in a modern democracy – or, as it is the case for the Eurosystem, in a subtle constellation of democracies like the European Union – means being accountable to public opinion.

In this respect, both public speeches and testimonies by the President of the ECB to the attention of the European Institutions and public opinion, as well as those by the Governors of National Central Banks to the attention of national Institutions and public opinion, are of vital significance. Indeed, a crucial part of our collective duty consists in tirelessly explaining the reasons and the arguments that underpin the decisions of the Governing Council.

In December 2000, the Eurosystem decided to release, for the first time, its euro area economic staff projections, with a view to improving transparency and communication.

Thus, from the point of view of the accountability of the central bank in a democratic society – that is to say the duty to explain, justify, convince, whenever possible, and take full responsibility vis-à-vis public opinion for decisions taken –, the Eurosystem strives to meet the highest standards of the main central banks in the world.

2. The euro significantly contributes to growth in Europe by enhancing the co-ordination of economic policies

A few years ago, it was necessary to convince a great number of sceptics, in Europe as well as in the rest of the world, that the euro would really be launched. Many observers believed that the single monetary policy would never succeed ! Facts have disproved this conclusion. However, other observers still sometimes evoke the supposed fragility of the euro area stemming from the supposed economic and structural divergences between euro area countries.

How can we answer this important question?

Firstly, monetary union does not necessarily imply that, at any given point in time, all participating countries will have the same rate of inflation or growth, even though the creation of the euro was based on the successful completion of a convergence process.

Let us take inflation for example. Inflation divergences across countries or regions are quite natural in a monetary union.

In the euro area, **long-term convergence** to a **common level** of prices naturally gives rise to different inflation rates across countries. The convergence of productivity and living standards creates a trend towards price convergence.

Now, present differentials in the Euro area are not very large, in comparison with those sometimes observed in the United States, which is a long established monetary union of comparable size.

My intimate conviction is that we will witness further European integration and, in the medium term, an increasing correlation of economic developments in the area. Several academic studies show that business cycles are becoming more synchronous across Europe.

***Secondly*, the question has often been raised as to whether EMU can be a success without some form of enhanced political union.** Indeed, to achieve this, the correct mix is required between fiscal, economic and monetary policies.

In the European Union, Member States are responsible for conducting economic and fiscal policies. We therefore believe that these policies should be closely co-ordinated. Co-ordination is stressed in the Treaty itself, which requests that Member States treat national economic policies “as a matter of common concern” and subject them to a multilateral procedure. Naturally, this economic co-ordination can in no way undermine the independence of the ECB and the Eurosystem.

Even more importantly, the euro area possesses institutional mechanisms which are conducive to an appropriate policy mix: the Stability and Growth Pact includes, on the part of the Member States, strict fiscal requirements. I will cite three economic justifications for the Treaty provisions that gave rise to the Stability and Growth Pact:

– First, by keeping a rein on the fiscal policies of the EMU Member States, the Pact ensures a satisfactory policy mix within the euro area. This is essential for monetary policy, in order to counterbalance the fact that Europe does not have a federal government and hence no significant “federal” budget. Mutual surveillance and close co-ordination of fiscal policies are the responsibility of the "Eurogroup" and of the Ecofin Council. Keeping the deficit below 3 % of GDP, and achieving budgets that are "close to balance or in surplus" in the medium term, ensure a balanced policy mix throughout the euro area.

– Second, the Pact helps to prevent well-managed economies from having to bear an unjustified risk premium on interest rates, resulting from the poor management of other EMU economies, by setting up a penalty system for excessive deficits.

– And lastly, the Stability and Growth Pact disproves the assertion that the euro area has no automatic stabilisers in the event of asymmetric shocks to a Member State. Indeed, by urging governments to aim at a fiscal position "close to balance or in surplus" in the medium term, the Pact enables them to allow budget deficits to increase during periods of specific national difficulties without exceeding the 3% reference value. In short, it enables countries to create a fiscal buffer during periods of normal economic conditions. This buffer can be drawn on to counter economic divergences or asymmetric shocks during economic downturns. But of course, the extent to which Governments can let automatic stabilisers play strictly depends on the initial level of the fiscal balance; obviously countries which still have fiscal deficits have less room than countries with budgets close to balance or in surplus.

II. The Euro itself is a catalyst for further progress

While many acknowledge that the introduction of the euro on 1 January 1999 was broadly successful, one may ask, at this juncture, what the conditions are for the full and ongoing success of the euro in the medium and long term. What is very encouraging in this respect is the fact that, in a number of areas, the euro in itself appears to be a catalyst for meeting these conditions.

1. The euro deepens and completes the single market

a) The euro makes the **completion of the single market** possible. It enables the productive sector and companies to achieve significant economies of scale, and all European savings to be allocated to the most efficient investments. It also enhances the transparency of the market and boosts competition and innovation to the benefit of consumers. However, the ultimate objective of the single market could not be fully achieved while monetary barriers continued to prevent the free flow of goods, services and capital by imposing unpredictable and erratic exchange rate movements and transaction costs. The last step in this process will be the euro cash changeover at the end of this year; it will enable not only companies but all our citizens to enjoy all the benefits of using the same monetary instrument throughout Europe, just like Americans do today with the dollar throughout the United States.

b) Moreover, the introduction of the euro brings about a **significant change in the economic and financial environment**.

The introduction of the euro has been a strong catalyst for mergers and acquisitions in the euro area. The European M&A market has been in 2000 one of the most dynamic in the world with operations totalling around one trillion euro.

The single monetary policy encourages structural changes in the financial sector, in both the euro area money market and longer-term capital markets. This gives euro area investors greater possibilities and improved financing and investment conditions.

– From the beginning of January 1999, cross-border **money market** transactions increased sharply, to reach almost two-thirds of total activity on all money market segments. The unsecured deposit interbank market —which is mainly concentrated on the shortest maturities— is highly integrated. The integration of interest rate markets within the euro area is a key achievement which deserves to be underscored. EONIA and EURIBOR have provided the market with uniform benchmarks that are fully accepted by all market participants. This is reflected, for instance, in the amount of daily transactions and the huge development of the euro interest-rate swap market.

These structural changes in the euro area money market have prompted market participants to concentrate their euro cash management activity in order to take advantage of the higher liquidity levels on the secondary market. Needless to say, such integration has to be brought to fruition in the other segments of the money market, i.e. the repo market and the short-term securities market. Further integration will enhance the efficiency of the euro area financial markets and will be beneficial to both borrowers and investors.

– As regards **stock markets and bond markets**, major progress has been made in terms of integration.

According to recent statistics, the euro, together with the dollar, appears to have been a major bond issuance **currency in the first semester of 2001, with the euro accounting for close to 40% of total issuance. Furthermore, European investors have substantially diversified their bond portfolios since the introduction of the euro, prompted by the removal of the exchange rate risk. This enables them to achieve better performances for a given level of portfolio risk.**

Additionally, I would like to draw your attention to current trends in mergers or close co-operation between stock exchanges, securities settlement systems, clearing houses, and similar institutions. Had the euro not been created, would it have been thinkable that the Paris, Brussels and Amsterdam exchanges merge to create EURONEXT and recently conclude another major alliance ? Undeniably, the introduction of the euro is fostering very large-scale market restructuring throughout Europe.

There are still some barriers to further integration of EU capital markets. In this regard, the Eurosystem has welcomed the objective of the European Council meeting in Lisbon in March 2000, to accelerate completion of the internal market for financial services, and to set a tight timetable so that the Financial Services Action Plan may be implemented by 2005 ; a regular review of this Plan is made by European authorities, and progress is well under way. The Eurosystem also supports the strategic conclusions of the Committee chaired by A. Lamfalussy on the integration of the European securities markets, ratified by the European Council meeting in Stockholm in March 2001: we are convinced that the implementation of these broad guidelines and the new cooperation structures at the European level will help to improve capital allocation in Europe and foster developments on equity markets in line with monetary policy requirements.

2. The euro is an incentive for further structural reforms

a) The euro, per se, is also a strong **catalyst for structural reforms** in all non-financial domains in Europe: a single currency facilitates the comparison of prices, taxes and earnings. The euro could encourage "cross fertilisation" of best practices through increased co-ordination of Member States' structural policies in areas such as the labour market, education and training, job creation incentives, effective welfare safety nets, etc. For this reason, the European Council, meeting in Luxembourg in December 1997, explicitly mentioned structural policies among the items selected for reinforced co-ordination. The Lisbon European Council further enhanced the medium-term strategy necessary for structural reform in the Union. The following developments are a step in the right direction: the emphasis on deepening the single market, the setting of indicators allowing comparisons of best practices among the Member States, and the Broad Economic Policy Guidelines which will examine the structural issues closely. The recent European Council meetings in Stockholm in March 2001 and Gothenburg in June 2001 confirmed these guidelines and even added a number of important issues such as the consequences of the ageing population in the European Union, the role of biotechnologies in economic growth, and the environment. The European Heads of State and Government, meeting in Ghent a couple of weeks ago, called for an acceleration of the whole process.

All European countries must resolutely pursue the reforms they have already initiated. It must be acknowledged that much has already been done, in particular with the implementation of the single market. However, continental Europe is still experiencing levels of unemployment that are too high, despite the fact that the unemployment rate has been declining significantly in most of its economies for the past three years. According to the IMF, the OECD and central banks, 75% of unemployment is of a structural nature, i.e. generated by an environment which handicaps job creation.

There is no doubt that EMU stimulates structural reforms on the labour market. With increased capital mobility and the smooth functioning of the single market, firms will become increasingly sensitive to the general environment in terms of their competitiveness when choosing a particular location in the euro area. The actual process of selecting an investment location within the euro area will be a major incentive for undertaking the necessary reforms.

b) Besides structural reforms, a strong emphasis must be placed on **competitiveness.**

Pre-euro economic policy required careful monitoring of the balance of payments and the foreign exchange and interest-rate markets. The authorities received constant feedback on key indicators affecting national economic performance and could then react accordingly. These indicators were sensitive, multiple and very reactive.

At present, with the advent of the single currency, economic managers must monitor the relevant competitiveness indicators with even greater vigilance, as economic policy errors could have slower and more insidious repercussions, such as rising unemployment and weak growth.

The rules of a market economy continue to apply to all euro area countries. Jobs are created by consumers – totally free to purchase whatever they wish – when they choose the goods and services that they deem to be best value for money. Companies – totally free in their investment choices – locate their business according to the relative competitiveness of the different possible sites. It is therefore necessary to monitor competitiveness even more closely than before, in particular unit production costs, and the tax and regulatory framework.

The multilateral surveillance carried out in the context of the Eurogroup, will help monitor competition trends in each euro area country and in the zone as a whole and, where necessary, suggest appropriate adjustments.

III. A smooth changeover to the Euro will also be a determining factor for Europeans' confidence in their new currency

Of course, the Eurosystem is at the heart of the euro cash changeover process. Our challenge consists in replacing all national monetary units by the euro in all monetary and financial relations of public administrations, banks, enterprises, businesses and citizens.

The first contribution of the Eurosystem is the **euro banknote production**. Today, more than 12 billion banknotes have been manufactured, out of a total of 14.9 billion. The launch stock is almost ready. The manufacturing process has been carefully monitored, in accordance with state of the art security standards. The new banknotes combine many of the highly effective security features already used in the national banknotes of the euro area with a number of additional features specifically used for the euro. These security features provide all persons handling cash, especially the general public, with the means to carry out a rapid, easy, and effective examination of the euro banknotes. Special attention has also been given to the needs of the blind and partially sighted.

The Eurosystem also plays a key role in the supplying process of euro banknotes and in the withdrawing process of former national monetary units. At the national level, each central bank of the euro area works in close co-operation with credit institutions, security companies, shopkeepers and police forces. This fruitful concertation is essential to the success of such a huge operation, on both fields of logistics and security.

The "non-cash" euro is already in use

The final stage of the introduction of the euro will include two changeovers: *the changeover to the non-cash euro*, which concerns all book-entry transactions (cheques, bank accounts, bank card payments, transfers, loans, etc.) and *the changeover to the cash euro*, which concerns banknotes and coins.

This summer, banks in France started to systematically convert bank accounts into euros and provide customers with euro cheque books. In various participating countries, in particular France, all bank accounts have already been converted . It is now up to each citizen in the euro area to establish a new scale of values for the currency and to make payments in euro. In this respect, retailers have a fundamental role to play: their active participation and their readiness to accept payments in euro will greatly facilitate the euro changeover as a whole.

The cash euro will be in circulation within 8 weeks

As regards the cash euro, the main task now consists in frontloading the banknotes and coins so that, on 1 January 2002, transactions can be carried out smoothly in the best possible security conditions. To achieve this, frontloaded coins are supplied to credit institutions. Banknotes will soon be provided to them (as of 1 December in France). Retailers will also be provided with frontloaded banknotes and coins. Furthermore, in order to familiarise the public and to facilitate the giving of change as of 1 January 2002, individuals will be able to obtain, as of mid-December, packs of euro coins known as 'euro starter kits'; these coins cannot be used for payments before 1st January 2002.

As of 1 January 2002, banks will only deliver euros, retailers will give change in euro and ATMs will supply euro banknotes only. A few days after this date, almost all transactions will be carried out in euro.

Beyond technical aspects, the Eurosystem –and also public authorities- have an important responsibility in **informing the general public** on the challenges ahead, the deadlines and the practical aspects of the euro cash changeover. The success of the global process depends heavily on the confidence of the general public and cash handlers as well. Preparing people to be well informed and to feel confident in using the euro banknotes and coins is the overall objective of the *Euro 2002 Information Campaign* conducted by the Eurosystem. This campaign aims to reach the general public through the mass media. It is closely supported by a Europe-wide Partnership Programme with more than 2 600 national and international organisations. It has now entered into an intensive information phase, since the unveiling of the euro banknotes and their security features by our President, W. Duisenberg, on 30th of August. As Mr Duisenberg stressed, this event was more than a mere technical presentation, but took on an historical and symbolic dimension. On 1 January 2002, we will have the honour of witnessing the largest currency changeover that the world has ever experienced. This will be the crowning achievement of a long economic and political process which led to the creation of Monetary Union on 1 January 1999. This unique event in European history will help to ensure lasting prosperity, which is not only in Europe's interest but that of the rest of the world as well.

Lastly, speaking in front of bankers, financial institutions, business executives and journalists, I would like to make the following remarks as regards the present situation:

-first, the main message in the present exceptional circumstances, is that the first quality of all Institutions, all economic leaders, all enterprises as well as households is to keep one's nerves. The best gift we could give the terrorists would be to change our plans, to cancel endeavours, to delay decisions, to reduce investment or consumption. We, Institutions, enterprises, individuals had and have projects : let us realize them, in time, and unchanged.

-second, let us beware of fashion. It was still fashionable, a year ago, to embark on vibrant eloge of the new economy, to predict the end of the business cycle and to forecast for ever very high level of productivity progress and buoyant economic growth. To-day some kind of herd behaviour drives a lot of observers and actors in the opposite direction: overwhelming pessimism as regards the present situation and the economic future. Both attitudes are equally totally inappropriate. It is up to the Central Banks to remain moderate in their judgments, pragmatic and lucid in the various circumstances and to offer an anchor not only for monetary and financial stability but also for stability of judgment.

-third, fostering confidence is a major contribution of the Eurosystem to the prosperity of the European economy. Confidence is a very precious ingredient in the present European conjuncture, as recently emphasized by the European Council in Ghent : confidence in the euro, in price stability, in its ability to be a highly reliable instrument for savings, in its medium and long term solidity. Confidence of the consumers in price stability underpins growth through dynamic household consumption – which is today a major motor of economic growth. Confidence of the savers underpins growth through a favourable financial environment.

Thank you very much for your attention.