Guy Quaden: The Euro - a milestone on the path of European integration and a contribution to world economy stability

Keynote address by Mr Guy Quaden, Governor of the National Bank of Belgium, at the OECD Forum, Paris, 14 May 2002.

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It is a great honour and pleasure for me to address this important Forum of the OCDE on the theme of the euro.

On 1 January 2002, the euro was physically introduced in the form of banknotes and coins. This event marked the conclusion of the changeover to the single currency, which had been initiated three years earlier, on 1 January 1999, when the non cash euro was successfully introduced in the money and financial markets. With effect from 1 March 2002, the euro has become the sole legal tender in the 12 countries of the euro area.

The success of the euro cash changeover has surpassed all expectations. That such an unparalleled logistical operation took place almost without a hitch bears witness to Euroland's operational capability. Such a massive and complex project could in fact only be successfully completed thanks to meticulous preparation and the all-out efforts of innumerable people, authorities, enterprises and associations working together in a constructive and co-operative spirit, in the public and private sector alike. European citizens have accepted their new money rapidly and enthusiastically and have chosen to be actors and not merely spectators in the changeover. They have helped to write a decisive page in the history of modern Europe whose significance far transcends the purely monetary field.

In my presentation today I first would like to analyse the implications of the introduction of the euro, both as a completion of the single market and for the creation of a new framework for economic policy. Thereafter, I would like to explore three important challenges for the euro area: firstly to increase the growth potential and growth performance of Europe's economies, secondly to reinforce policy co-ordination and political cohesion between the countries of the zone, and thirdly to prepare for and to succeed its enlargement and the accession of new members. I would conclude with some comments on the international aspects of the euro.

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European monetary union pursues two, interrelated economic objectives: more efficiency and more stability.

Let me start off with more efficiency. The euro is, in the first instance, a completion of the single market. The introduction of the euro has created one of the world's major economic areas. The young euro area is an important economic power, with a population of around 300 million people, having a considerable purchasing power, which is only exceeded by the United States. Thus, the Member States of the euro area together represent some 15% of world GDP, which is less than the United States - with about 20% - but twice as much as Japan. By way of comparison, the biggest country of the euro area by itself is estimated to represent only 4.5% of world GDP.

Monetary union also implies that some exchange rates do no longer exist, as for instance the rate of the Belgian franc against the German mark or the Italian lira. In the past, the volatility of these exchange rates has been most harmful to the closely interdependent national economies of the European common market. Let's think back for instance to the ERM-crises in 1992 and 1993.

The single currency has completely removed exchange rate risks for exporters and importers, debtors and creditors across the 12 countries of the euro area and has thus eliminated the costs of hedging exchange rate risks vis-à-vis other euro area countries.

I notice in passing that this "internal exchange rate" stability has often been overshadowed by a disproportional interest in the floating of the US dollar-euro exchange rate. The dollar/euro exchange rate movements have, in fact, been comparable with the dollar's historical fluctuations vis-à-vis the European currencies (in particular the German mark) prior to the introduction of the euro.

The euro is leading to an increased transparency of prices and greater competition and a thorough integration process has taken place in the area. The integration of the money market and the disappearance of the exchange rate risk have provided a boost to the integration of other financial markets, such as the bond market and the equity markets, be it to a lesser extent.

The stability effects which the euro's arrival has brought about and which have improved growth potential in the zone, cover other types of stability: price stability and fiscal stability.

1. There can be no doubt that both deflation and inflation are harmful for both output and welfare in the medium term: they distort the information contained in the price system, imperceptibly change the real value of contracts and savings and heighten uncertainty. They consequently disturb the allocation of resources, the investment process and the income distribution. In the case of Europe, this consensus on the contribution of price stability to promoting long-term growth is explicitly enshrined in the Treaty of Maastricht which states unambiguously that the primary objective of monetary policy is to maintain price stability. The Eurosystem, which associates the European Central Bank and the national central banks of the 12 euro countries, is convinced that by fulfilling this mandate, monetary policy is making its most effective contribution to the realisation of strong output growth as well as to sustainable employment prospects.

   As part of its monetary policy strategy, the European Central Bank has published a quantitative definition of price stability. It aims to create a stable anchoring point for price expectations, making it also easier for the public to judge its actions. Price stability is defined as an annual rise in the harmonised index of consumer prices for the euro area of less than 2%. It must be maintained in the medium term.

   Central bankers cannot avoid that external shocks, such as a rise of commodity prices on the international markets, lead to a temporary increase in inflation. However they do have to prevent second-round effects and must ensure that the internal value of the currency will be maintained in the medium term.

   That the policy of the Eurosystem has been convincing in this respect can be seen from the moderate inflation expectations as evidenced, among other things, by the level of long-term interest rates. Together with the present easy monetary conditions, the continuance of low risk premiums in euro long-term interest rates is one of the factors from which the economic recovery in 2002 can draw strength.

2. Another stability-related aspect in the new European economic policy framework is the discipline of fiscal policies.

   The convergence criteria leading to the last stage of Economic and Monetary Union have played an important part to ensure a stable environment. In addition, the institutional set-up and different permanent procedures within the European Union aim to promote the stability-oriented policies further. The Stability and Growth Pact, multilateral surveillance and peer pressure are important tools to this end.

   Monetary policy decisions are centralised but fiscal policy is still conducted at the level of the Member States, in accordance with the subsidiarity principle. This leaves room for manoeuvre regarding the composition of public spending and revenues, in line with national preferences and with possible differences in the cyclical positions. However decentralised fiscal policies had, within the eurozone, to take into account the potential for spillover effects.

   The present framework has been designed to minimise the risk of negative spillovers (across countries and across policies) from inappropriate fiscal policies. Crucially, the Treaty contains an obligation to avoid "excessive deficits". This constraint, together with procedures for a multilateral review of national fiscal policies, has been further specified by the Stability and Growth Pact. The Pact stipulates quantifiable deficit rules, which provide a clear policy orientation for the budgetary authorities in the Member States.

   It is not correct to describe the Pact as a fiscal straitjacket. In a monetary union a more prominent role is generally assigned to fiscal policy in dealing with cyclical movements. If correctly applied, the Stability and Growth Pact certainly offers the necessary scope for this. Indeed, the obligation for the EU Member States to aim for a budget which is "close to balance or in surplus" "over the medium term" does make it possible to allow the nominal budget balances to fluctuate according to the changing cyclical circumstances. The so-called economic stabilisers can operate freely in a period of economic slowdown in the countries having structurally balanced their budget at the top of the cycle.

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The changeover to the physical euro has concluded a chapter in the history of the European integration but not the book. After the introduction of the new currency, the countries of the euro-zone are facing three main challenges.

1. The economic outlook remains subject to uncertainties but after a disappointing year 2001 globally business confidence has markedly improved in the euro area over the last few months and the conditions for a sustained upswing are in place, including favourable financing conditions. While the recovery is expected to initially proceed at a gradual pace, real GDP growth rates should gravitate towards potential growth later this year.

   The growth problem has however two dimensions: short term and long term. Potential growth in the euro-area is estimated at between 2¼ and 2½%, still noticeably less than in the US. This growth potential needs to be increased. Yet the solution is not necessarily, I think, to duplicate the American "model". The experience of some countries in Northern Europe (Scandinavia) indicates that it is possible to combine a level of social protection conform to the European preferences with high rates of participation to the workforce, technological innovation and economic growth comparable to those of the US.

   Monetary unification is in itself a major structural reform, which has already stimulated other reforms. Yet further strides are necessary in order to increase overall productivity and to include in working life those who are still unemployed.

   The euro area countries must raise the "speed limit" of their economies by continuing to improve the efficiency of labour and products markets, to encourage the entrepreneurship and to foster a knowledge-based economy.

2. A question often asked is whether it was appropriate to introduce monetary union between different European countries before political union. It is true that in the case of the US for instance, political unification preceded monetary unification. There is however no precedent or pre-set scheme for the construction of Europe.

   The single currency was the desirable complement to the single market and European leaders took advantage of an exceptional political momentum in the late 1980s to proceed with monetary union.

   This monetary union can operate - and it has been proven for more than three years - in the current institutional framework with monetary policy determined centrally by the Governing Council of the European Central Bank, with a high degree of independence and a clear mandate, and national fiscal policies which, though autonomous, are bounded by the rules of the Stability and Growth Pact. The soundness of the euro is essentially based on the strength of the area's economy (the largest trading bloc in the world) and on price stability which safeguards the euro's internal value, given that its external value inevitably fluctuates on account of differentials in growth and interest rates, particularly vis-à-vis the US.

   Having said that, I add, speaking in a personal capacity that new progress in the economic policies co-ordination among the Member States of the euro-area and more political cohesion among them inside and outside Europe would be welcome to consolidate monetary union and deepen European integration.

3. The prospect of enlargement is another reason to adapt the EU's institutions and procedures. The EU is indeed facing another major challenge: many countries in the rest of Europe are knocking on its door.

   The accession criteria to the European Union were defined at the European Summit in Copenhagen in 1993. The political criteria concern the existence of stable institutions guaranteeing democracy, the rule of law, respect for human rights and protection of minorities. According to the economic criteria these countries must be viable market economies. In this connection it is necessary to verify whether prices and trade have been liberalised and whether a binding legal system, including property rights, is in place. These countries must also be competitive, i.e. capable of withstanding competitive pressure and market forces within the Union. Finally, an institutional criterion concerns the adoption of the "acquis communautaire".

Moreover the accession criteria to the monetary union are well known: there are the famous Maastricht criteria relative to the moderation of inflation, the avoidance of excessive public finance deficits and the stability of the exchange rate.

In many accession countries substantial progress has already been achieved in different fields and one can expect the participation of over ten new Member States to the European Union in the coming years and later on to the monetary union. However a lot remains to be done.

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I shall now move on to the last topic of my speech: the international role of the euro.

In the past, for economic and political reasons, some countries have adopted an active stance with regard to the internationalisation of their own currency, by either fostering or hindering its external use. For its part, the Eurosystem has adopted a neutral stance. This means that it neither pursues the internationalisation of the euro as a policy goal, nor does it attempt to hamper its use by non residents. The international role of the euro is and will be determined by the choices of market participants in the context of increasing market liberalisation and integration. There is place for at least two international currencies: in that field too competition is beneficial.

Given the weight of the euro area in the world economy and the legacy of the former national currencies of the area in financial markets, the euro has already become the second most widely used international currency behind the US dollar.

As an anchor currency, the euro has largely inherited the role played by some of its legacy currencies (e.g. the German mark and the French franc). The euro plays a role as a peg in 55 countries outside the euro area, mainly in countries in the rest of Europe, Africa and the Middle East having close trade and historical links with the euro area countries. Arrangements adopted range from very close links to the euro to looser forms of anchoring.

With regard to other functions, the euro's international role has remained more limited. The US dollar remains the main reserve currency and the dominant pricing and quotation currency. The predominance of the dollar is attributable mainly to the combined and reinforcing effects of network externalities and economies of scale in the use of the leading international currency.

Future developments in the international use of the euro are likely to be influenced by two main factors - size and risk. With regard to the size factor, a broad and liquid euro area capital market may lead to greater use of the euro through lower transaction costs. This may, in turn, facilitate the development of the euro as a vehicle currency for trade and commodity pricing. In addition, if international investors and issuers consider the euro to be a stable currency, they will hold more euro assets to minimise risks in their internationally diversified portfolios.

Two processes of great significance for the world economic and political order have unfolded in the last decades: economic globalisation and European integration. They are partially linked. Yet they have different roots. One is the fruit of technological process and the free forces of the markets. The other has been motivated by political will and vision.

Regional integration and international co-operation are surely appropriate means to promote more stability and economic growth in the different parts of the world and to contribute to humanise the process of globalisation.

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The euro banknotes show windows, gateways and bridges. These symbols of openness and communication will help both to promote a feeling of shared identity and to further strengthen exchanges among the nations of Europe. At the same time, these symbols are a reflection of the European attitude towards the rest of the world.