

Willem F Duisenberg: The first nine months of the euro cash era

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the International Imaging Industry Summit, Schloss Bensberg, Bergisch-Gladbach, 24 September 2002.

* * *

Ladies and Gentlemen,

It is a great pleasure for me to be invited to the International Imaging Industry Summit, on the eve of the world's leading trade fair "for the photographic and imaging sector", as the website says. Let me start by drawing a parallel between the Photokina and central banking, which, I must admit, is not an easy task. Both activities – and this is an important point – are future-oriented. In fact, a key objective of the Photokina exhibitors is to present "the future" here and now, in the shape of new products and new technologies. Also for central bankers, a future-oriented decision-making is crucial; in fact, it is an important element of a successful monetary policy.

A forward-looking approach was also taken by the creators of the euro. The single currency has been used as a non-cash payment instrument and unit of account since the start of 1999 and as a physical payment instrument since the beginning of this year. The introduction of the banknotes and coins was the last step in a process which formally started at the European Council held in Maastricht in December 1991 and led to the signing of the Maastricht Treaty in 1992. Euro cash has now been in circulation for almost nine months and, according to a recent survey by the European Commission, around 85% of the population of the euro area countries found the changeover to the new money a straightforward process. It was completed by the end of February 2002, when the euro banknotes and coins became the sole legal tender in the 12 countries.

In my speech today, I shall not only look to the future, but shall also look back a little, over the first nine months of the euro cash era. Putting more than eight billion banknotes and close to 39 billion coins into circulation was a logistical operation of truly gigantic proportions. That it went off so smoothly was thanks to the joint efforts of all parties involved and especially to the currency's good reception by the public. First, I shall address developments in currency in circulation before, during and after the cash changeover. Second, I shall consider the use of the euro outside the euro area. In fact, there is evidence of considerable demand for euro banknotes also outside the euro area and particularly in countries neighbouring the EU. Finally, I'll be talking about a major concern of people in the euro area, namely the perceived impact of the euro banknotes and coins on inflation, or the "teuro" as this phenomenon is popularly called in Germany. While it is true that in some sectors, especially in services, price increases have been made for various reasons, the across-the-board impact on overall consumer price developments has been small. I will come back to this later as well.

Currency in circulation and banknote developments before, during and after the cash changeover

Let me first of all consider what happened to the currency in circulation and euro banknotes in the months before, during and after the cash changeover.

The period before the euro cash changeover saw a significant decline in currency in circulation; currency in circulation is defined as the value of banknotes and coins held by non-banks – which in turn means currency holdings by residents of the euro area not belonging to the euro area banking sector and by non-residents. From December 2000 to December 2001, the volume of national or "legacy" currency circulating in each of the euro area countries decreased by around 30%.

In the first two months of this year, currency in circulation – was strongly influenced by the cash changeover. Both euro banknotes and legacy banknotes were used in parallel to make payments. In addition, in order to make it easier to give change in the first two weeks after the cash changeover, retailers held large amounts of small euro banknotes, especially the EURO 5 and 10 banknotes. These holdings led to a steep increase in currency in circulation in January. In February, the amount of legacy banknotes held by non-banks as well as the precautionary holdings of small euro banknotes declined, leading to an overall reduction in currency in circulation.

Banks also held more banknotes than usual as a precaution and, in part, for logistical reasons. Higher priority was given to supplying new euro banknotes to customers than to returning legacy banknotes to

their respective national central bank, and so the latter process took some time. As a result, the number of euro banknotes in circulation reached its peak on 15 January 2002 [8.1 billion banknotes]. Thereafter, the number of euro banknotes in circulation fell until the end of August 2002 [to 7.3 billion banknotes]. In particular, the number of EURO 5 banknotes in circulation declined by 51% and the number of EURO 10 banknotes by 30% between mid-January and the end of August.

In contrast to the decline in the number of small banknotes in circulation, the demand for large denominations increased steadily in the first eight months of 2002. The strongest rise in demand was for the EURO 500 banknotes, which more than doubled between mid-January and the end of August [+120%]. Demand also rose during this period for the EURO 100 banknotes, by no less than 60%. This shows that there was a rapid increase in the hoarding of banknotes in the first months of the euro cash era. Evidently, the denominational structure of the banknotes in circulation is still developing in response to the banknote requirements of cash users.

Related to the substantial rise in large banknotes, from March onwards, currency in circulation increased by around EUR 10 billion each month. While the volume of currency in circulation so far has remained below the level in January 2001, this development indicates that economic agents are quickly re-building their currency holdings.

Let me also say a few words on the euro coins. As a large quantity of euro coins was transferred to banks and other professional groups prior to 1 January 2002, the increase in the number of euro coins in circulation during the first two weeks of the changeover period was only small [2.6%]. The circulation of euro coins reached its peak in mid-January 2002 [38.6 billion coins]. At the end of August 2002, there were around 36.7 billion coins in circulation, worth EUR 11.5 billion.

The successful introduction and acceptance of euro cash has been certainly aided by the high quality of the euro cash. The euro banknotes incorporate a variety of modern security features that are easy to check. Their effectiveness is proven by the fact that in the first half of this year the number of euro banknote counterfeits amounted to less than 7% of that of the legacy currency counterfeits circulating in the same period last year. I can assure you that banknote research and development work within the Eurosystem is ongoing and aims to maintain the integrity of euro banknotes.

First estimates of the use of the euro outside the euro area

Let me now turn to the demand from outside the euro area for the euro in the first half of this year, in terms of cash and deposits. I should point out that, because of the anonymity of cash, central bankers are not usually able to determine exactly where the banknotes they have issued are circulating. Some indications are provided by cross-border transfers of banknotes via banks, but banknotes which are carried across borders by individuals are not registered.

Of all the legacy currencies circulating outside their "home" territory, it was the Deutsche Mark banknotes which accounted for the largest proportion. Moreover, people living outside the euro area also used to a certain extent some of the other legacy currencies, such as the French franc, the Italian lira, the Austrian schilling and the Spanish peseta. A large share of the legacy currencies was believed to be circulating in central and south-east Europe as well as in Turkey. Therefore, the introduction of euro cash at the beginning of 2002 was a major event not only for the euro area but also for a number of neighbouring countries where legacy banknotes from the euro area were circulating.

The euro cash changeover and its aftermath offered a unique opportunity for the European Central Bank to collect first-hand information on the foreign circulation of the euro. Such information can be derived from data on the frontloading of euro banknotes to destinations abroad, from data on cross-border shipments of euro banknotes by banks, which probably comprised the main outflow in the first months of the euro cash era, as well as from evidence provided by a number of central banks in countries neighbouring the EU. All in all, although the available data and estimates are characterised by various degrees of uncertainty, there is evidence that the euro is used in neighbouring countries to a significant extent, either in cash or deposit form.

Let's consider cash first. The cash changeover outside the euro area started as early as 1 December 2001, in order to facilitate the conversion to the euro of legacy currency banknotes held by non-euro area residents from 1 January onwards. Non-euro area central banks and international banks abroad received euro banknotes to enable them to meet the initial cash needs of the public and business. Banknotes worth almost EUR 5 billion were shipped outside the euro area in December 2001, more than half of them destined for eastern and central Europe, and Turkey. Since January, banks have

continued to ship euro banknotes outside the euro area in order to replace legacy currency banknotes and to meet new demand. Between December 2001 and June 2002, an accumulated net amount of around EUR 23 billion euro banknotes was shipped abroad via the banking system.

In the mid-1990s, the Bundesbank estimated the Deutsche Mark banknotes circulating outside Germany to be worth between EUR 32 and 45 billion. If this is taken as a rough approximation of the amount of legacy currency banknotes held outside the euro area, then the available evidence suggests that a considerable part of this has already been converted into euro banknotes.

Let's now consider euro-denominated bank deposits. They also played an important part in the cash changeover outside the euro area. Indeed, before the cash changeover, several non-euro area countries encouraged households to deposit their legacy currency cash holdings in euro-denominated accounts, rather than exchange them directly for euro banknotes. Credit institutions, particularly foreign-owned banks, widely advertised euro-denominated accounts at attractive conditions. This strategy was intended to reduce both the logistical and transaction costs related to changeover operations. In some cases, especially in south-east Europe, another objective was to boost confidence in banking systems. In co-operation with a number of central banks in countries neighbouring the euro area, the ECB has gathered data on the scale of these developments. Overall, in around 30 countries, euro-denominated deposits increased by a total of more than EUR 13 billion in 2001. Information for the first months of 2002 suggests that this may be a lasting phenomenon as euro-denominated deposits decreased only slightly.

In a nutshell, the available evidence tends to indicate that most of the legacy currency banknotes have been converted into euro, either in cash or deposit form. This suggests that the euro has successfully replaced the legacy currencies in the regions neighbouring the EU.

Let me add that – despite the considerable amount of euro banknotes transferred abroad – foreign circulation of euro banknotes only constitutes a limited proportion of the total currency in circulation. The estimated amount of euro banknotes circulating outside the euro area at the end of June accounts for only 8% of total currency in circulation and only 0.4% of the monetary aggregate M3. Therefore, while the ECB monitors these developments closely, they currently play no significant role in the assessment of monetary developments in the euro area with regard to price developments.

Demand for euro banknotes over the longer term

Let me also take a somewhat longer-term perspective with regard to the demand for the euro in the euro area and outside.

As already mentioned, a preliminary interpretation based on developments in the first months of the euro cash era suggests that the negative trend of currency in circulation which was observed before the cash changeover is being reversed relatively quickly. It would seem that currency holdings for transaction purposes, but also for hoarding, are being built up fairly quickly by people in and outside the euro area. But as the demand for cash has not yet taken full shape, it is too early to assess whether the cash changeover will have a long-term impact on the use of cash by the general public and, if so, in which direction. Certainly, a number of domestic as well as foreign factors will play a role in the longer-term demand for euro banknotes:

First, with regard to domestic demand, the introduction of the single currency itself has facilitated the use of cash across the euro area countries. At the same time, however, the introduction of the euro makes it possible in general to economise on cash holdings for cross-border uses, which might lead to lower cash holdings.

Second, in most of the euro area countries, the euro banknote denominations are higher than those of the national legacy currencies. This might lead to changes in cash holding habits.

Third, the further integration of the financial sector in the euro area tends to work in favour of lower cross-border transaction costs for electronic payment instruments such as credit cards. This might encourage greater use of electronic payment instruments in the euro area. At the same time, however, these factors also tend to result in lower fees for cross-border cash withdrawals.

Finally, regarding foreign demand for euro banknotes and coins, the close financial, economic and institutional links between the euro area and its neighbours suggest an ongoing and perhaps increasing foreign demand for euro banknotes, in particular, although probably not exclusively, in the EU's neighbouring countries.

Consequently, as these factors work in different directions, it is difficult to foresee the longer-term trend in banknote developments.

Impact of the cash changeover on price developments

Let me now turn to an issue which has attracted much publicity over recent months. There has been a controversy in many euro area countries about whether the introduction of the euro banknotes and coins has led to an increase in prices. According to a recent survey by the European Commission, more than 60% of euro area inhabitants believe that prices in all sectors have increased since January. Another 15% think that prices have risen in some sectors of the economy.

Let me first say that it is very difficult to separate out the impact of the cash changeover on prices with any degree of precision. Any price change could be due either to the changeover itself, because of, for example, rounding up to new eye-catching prices or the pass-through of cash changeover costs, or it might reflect a change in other cost factors, like wages or import prices. This implies that any estimation of the cash changeover effect on prices is surrounded by uncertainty.

In order to get some evidence on price changes which might be related to the cash changeover, it is informative to look at the sector level. Indeed, for specific services items, prices have increased more than usual, which could be related to the introduction of the euro. For example, eating out, having a haircut or having clothes dry-cleaned became significantly more expensive in the first few months of 2002, and many people in the euro area have noticed this, including myself. In general, price increases have mainly taken place in sectors with a low level of competition and where products are rather differentiated.

At the same time, however, it is important to realise that there have also been price increases due to factors unrelated to the euro. For example, in the early months of this year, the extreme winter weather in the euro area, particularly in the Mediterranean countries, led to severe supply shortages and thus to higher vegetable prices. Likewise, the rise in petrol prices in the first quarter of 2002 cannot be attributed to the cash changeover, but was the result of higher oil prices on the world market and, in some countries, higher taxes. The same applies to cigarette prices in several euro area countries.

Moreover, it has to be taken into account that the Harmonised Index of Consumer Prices, which is used for measuring consumer prices in the euro area, is a broad index covering a very comprehensive basket of goods purchased by households. While it cannot and is not supposed to reflect the cost of living of each single household, it reflects the average cost of living of a representative household in the euro area. Therefore, while some items in this goods basket may have gone up in price partly because of the cash changeover, many other items in the basket have not shown any significant price increases. In fact, some goods have actually become less expensive over recent months. One example which might be of particular interest to you, ladies and gentlemen, is the price level of photographic and cinematographic equipment: in July this year the prices of these goods were almost 3½ percent lower than in July 2001 across the euro area. Telephone calls have also become cheaper over this period. In other areas where competition is strong there were also price reductions associated with the euro.

Overall, it does not appear that the cash changeover has been a major factor in the overall development of euro area consumer prices. Eurostat, the official statistical agency of the EU, has estimated a cash changeover effect for the euro area on HICP inflation in the first half of 2002 of between 0 and 0.2 percentage points. Studies at the country level also point to limited overall effects, with some possible euro-induced price increases in certain sectors. For example, Germany's Federal Statistical Office, jointly working with the Deutsche Bundesbank, stated recently, that "the euro introduction has not had a considerable impact on the cost of living as a whole"⁽¹⁾ in Germany. While the effects may have varied across euro area countries and sectors, the overall impact of the cash changeover on the overall price level in the euro area has been contained.

This evidence, however, contrasts sharply with the concerns and discussions in many euro area countries about the impact of euro cash on consumer prices. One reason for the gap between empirical findings and public opinion might be the fact that the general perception of price changes is more strongly influenced by the prices of small-ticket goods and services purchased on an almost

¹ "Six months after the introduction of euro cash - an intermediate stock-taking in official price statistics", DESTATIS press release, 2 July 2002.

daily basis. Coincidentally, prices of some of these frequently purchased items, like tomatoes, petrol and tobacco products, went up, for the various reasons I have mentioned (such as winter weather, oil prices and taxes), at the same time as the introduction of euro banknotes and coins. Although these price increases were unrelated to the cash changeover, many people have unfortunately associated them with the changeover.

But it is important to realise that a complete picture can only be obtained by looking at a comprehensive measure of prices, including the prices of less frequent purchases. In fact, overall consumer price inflation has been around 2% during recent months, a level which is very similar to that in December 2001, just before the introduction of the euro banknotes and coins. In addition, the price prospects for the coming months point to a rate of around 2% in the euro area.

Over a longer period of time, the greater transparency resulting from the introduction of the euro and the move to exclusive euro pricing will strengthen competition in the retail sector and contain price pressures in the euro area. These permanent benefits and efficiency gains from introducing the euro will far outweigh the generally very small changeover effects on inflation.

Concluding remarks

Let me sum up. The introduction of the euro banknotes and coins has been a major success which was made possible by the thorough preparations of all parties involved and the good reception by the public. The euro banknotes make visible the Monetary Union and the close financial integration of the twelve euro area countries. We are very satisfied that the banknotes were immediately accepted by the public in the euro area. And as the foreign demand for the euro banknotes shows, the euro is much sought after outside the euro area as well. Finally, even though there have been effects on certain goods and services prices, the permanent benefits of the single currency and efficiency gains of introducing the euro will far exceed any short-term effects on inflation.

Ladies and gentlemen, I would like to thank you for your attention.