Ernst Welteke: European Monetary Union - experience and outlook

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the Svedbank, Stockholm, 19 November 2002.

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I

Ladies and gentlemen

It is good to be here in Stockholm. Thanks to a good friend, my connections with Sweden have grown deeper over the past few years. Today, I have the pleasure of sharing with you my views on experience of the Eurosystem during the almost four years of its existence.

I am well aware of the ongoing debate on your membership in the European Monetary Union. Therefore, our experience might be of particular interest to you. That relates to monetary and economic aspects as well as practical matters, such as the changeover of banknotes and coins.

In addition, you have asked me to extend my view and also give an outlook for the near future. Again, most of the major challenges for the monetary union stem from the process of enlargement. Too often, enlargement is only referred to with respect to eastern and southern Europe. To me, an equally interesting and important question is whether Sweden and other countries in northern and western Europe (UK, Denmark) will join monetary union.

I guess you may not have the answer to that yet. However, if I may, I would like to express a wish about that later on.

II

The primary objective of the European Monetary Union (EMU) is to maintain price stability. The Governing Council of the ECB has defined price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. At the same time, the Governing Council also stated that price stability “is to be maintained over the medium term”.

Looking at the annual HICP rate in the euro area over the past few years in the light of those requirements tends to reveal a mixed picture. It was only in 1999 - the year which started with the Eurosystem - that the annual rate of price increase, strongly influenced by developments in 1998, remained within the defined stability corridor at 1.1%. Since then, the price norm has not been met. In 2000, the average annual rate of inflation was 2.3%. In 2001, with Greece having joined the euro area, the figure was 2.5%. In the first nine months of this year, the rate was 2.2%. It is therefore no longer possible to speak of a short-term overshooting.

In its defence, the ECB-council can point to a number of exceptional circumstances during the past few years - events over which the ECB has no influence and which have intensified upward pressure on prices. First, there have been, at times, sharp increases in international oil prices and thus also in European energy prices. Second, BSE and foot-and-mouth disease in addition to unfavourable weather conditions, especially in southern Europe, led to a considerable rise in food prices at the start of 2001 and in early 2002.

Excluding the volatile components, energy and unprocessed food, the picture is significantly more favourable. This gives a core rate of below 2.0% in 2000 and, at 2.0% in 2001, a core rate on the edge of the price norm. In the current year, however, that figure will clearly be exceeded. All in all, the larger currency area has cushioned the substantial price shocks. Especially, no additional yield spreads have occurred.

So far, the general expectation that the euro area, with a single currency and a single monetary policy, would see a rapid convergence of price developments has not been fulfilled. Since 1997, there has been a trend widening in the range of data from the individual countries. This indicates that specific, persistent, national factors continue to shape price developments. One reason for this may be seen in consumer habits, which vary from country to country. Another reason consists in diverging price trends, especially in the sector of non-tradable services or services of limited tradability.

As a consequence, euro-area real rates of interest vary quite considerably. However, the national real interest rate is not the same for each sector. The relevant real interest rate differs according the different price developments. It is lower in the sector with higher sectoral inflation rates et vice versa. For the sector of tradables the real interest rates do not differ that much.

European Economic and Monetary Union has a population of 300 million people. That is around 20 million more than in the United States. However, overall output in the euro area is almost 30% lower and per capita income as much as one-third lower than in the USA. In many instances, there were expectations that there would be a real convergence - in other words a reduction in the prosperity gap.

The necessary strengthening of economic growth in the euro area - so it was hoped - would more or less occur automatically. In this context, reference was made, first, to the expansionary impact of interest rate convergence down to the lower German level in the run-up to Stage Three, which mainly benefited the former “high interest rate” countries. Second, it was expected that the introduction of a single currency would lead to a better allocation of the production factor capital as a result of the sudden improvement in capital market integration. Furthermore, an accelerated restructuring of the corporate landscape owing to an increased number of mergers and participations - added to more intense competition in the euro area - were supposed to act as a “fitness programme” for European enterprises. Significant positive growth effects were also forecast owing to the disappearance of the foreign exchange rate risk within the euro area.

So far, however, those expectations have only just started to be fulfilled. On an average of the years since 1999, the rise in overall output in the euro area, at just over 2% annually, has been noticeably slower than in the USA (2½%). The pace of expansion has also lagged behind that of the pre-ins, the United Kingdom and Sweden. The euro area has thus been unable to isolate itself from the cyclical slowdown in the USA, as had been hoped in early 2001. It has, in fact, more or less fully shadowed the price slumps on the US stock markets and the deterioration in sentiment of US investors and consumers, even though the bubble in the IT and telecoms sector was less pronounced here and the macroeconomic imbalances are less severe.

The differential in per capita income compared with the United States - where the population is growing considerably more quickly than in the euro area - has been narrowing somewhat since 1999, however. But this development is due to the fact that the USA was hit harder by the cyclical slowdown than the euro area was. Looking at the longer-term trends, the US lead in potential growth over the euro area - which the IMF puts at ¾ percentage point - is even larger than the difference in population growth. This means that, under these conditions, the per capita income between these two economic areas is even diverging.

The euro area’s growth performance has, on the whole, been unsatisfactory. This is revealed not least by the fact that EMU, despite some undeniable progress, still represents a quite heterogeneous economic area. This is shown by the wide spread of growth rates among the member countries. In 2000, for example, rates of growth ranged from just under 3% in Italy and Germany to 10% in Ireland. The differentials in growth across the euro-area countries did narrow in 2001 and 2002. However, a number of member countries converged on the low German pace of expansion - and not the other way round, as would actually have been desirable.

In almost every case, economic analyses of the euro area’s growth weakness come to the conclusion that the problems lie mainly on the labour market. The contribution made by the factor labour to economic growth in the 1991 to 2000 period was no more than roughly one-third as high as in the United States. The inadequate involvement of the factor labour in the production process is also reflected in the high core level of structural unemployment that has emerged, above all, in the larger euro-area member countries.

It follows from this that strengthening the forces of growth in Europe is not so much a macropolicy task but more a challenge to structural policy. In this connection, what is of key importance is the elimination of rigidities on the labour markets. Although significant efforts have been undertaken in that respect over the past few years, many pressing problems remain and governments as well as both sides of industry have to face up to them.

The development of the external value of the euro has been disappointing in the first two years after its introduction. It was not so much depreciation in itself that was felt to be surprising and exaggerated but rather its scale. At their peak, the exchange rate losses on an trade-weighted average against the 12 most important trading partners outside the euro area amounted to 23%. A crucial factor in this development was the strength of the US dollar, reflecting the decidedly robust pace of growth in the US economy up to early 2001. It is only since many high, and ultimately unfounded, expectations on the part of market players had to give way to a more sober assessment that this development has stabilised and, to a certain extent, gone into reverse. However, we are still a long way off from the exchange rate relationships that existed before the changeover to monetary union.

The depreciation has not inflicted lasting harm on the euro-area countries. The exchange-rate-related gain in competitiveness in trading with countries outside the euro area has provided growth in the region with an external mainstay. And the inflationary effects which intermittently strengthened the oil-price-induced external price surge have been brought under control by monetary policy.

In the long run, however, business in the euro area cannot rely on such advantages continuing. Ultimately, there is no option but to keep an eye on the cost-side risks and to undertake structural reforms in order to strengthen the efficiency and adaptability of the euro-area economies on a sustained basis from the inside.

In the second half of the 1990s, there was a significant improvement in the fiscal position of general government in the member states of the euro area. The average deficit ratio in the euro area initially continued to go down, as did the government debt-to-GDP ratio. The fiscal policy framework in the monetary union, which is enshrined in the Maastricht Treaty and in the Stability and Growth Pact, has played a crucial role in this. The majority of member states are now meeting the requirement, laid down in the Stability and Growth Pact, that budgets should be close to balance or in surplus under normal cyclical conditions.

However, some countries - including the largest economies in the euro area - have neglected to use the years of favourable cyclical development for consolidating their public finances. In many cases, welcome tax cuts were not adequately counter-financed by savings on the expenditure side, which led to a further deterioration in the underlying budgetary position. Together with cyclically induced strains, this has resulted in a situation where those countries are now finding it difficult to comply with - or are already overshooting - the 3% deficit ratio limit. Germany is among these countries. The EU-commission has already implemented the excessive deficit procedure.

The fiscal policy problems of some countries have occasioned a debate on possible changes to the Stability and Growth Pact, implying a softening of its terms. This would, however, jeopardise the objective of sound underlying fiscal policy conditions, which are a major and essential component of a monetary policy that is geared to stability. In order to preserve the credibility of the fiscal policy ground rules in the monetary union, what those countries need to do instead is undertake a speedy correction of the undesirable developments that have emerged and achieve structurally balanced budgets in the near future. This will make it easier for the European Central Bank to perform its task of maintaining price stability. Sound public finances, moreover, contribute to sustained economic growth and a long-term increase in employment.

Over the past four years, the Governing Council of the ECB has demonstrated that it takes its stability mandate seriously. With its consistent and forward-looking monetary policy, the Governing Council has succeeded in anchoring inflation expectations at the targeted low level. That success is all the more notable in view of the fact that price developments in the euro area since January 1999 have been shaped, as described earlier, by a series of negative shocks.

In terms of its monetary policy strategy, the ECB Governing Council has repeatedly had to contend with the accusation of a lack of transparency. Criticism was mainly aroused by the unclear weighting of the two pillars in the event of conflict. The ECB has now improved its communication with the markets to the extent that its interest rate decisions are, as a rule, correctly anticipated by the markets. But it still has to be said that the two-pillar strategy, owing to its complexity, makes heavy demands on the Eurosystem’s communications policy.

Following a two pillar strategy the ECB council does neither ignore the possible threats by monetary expansion nor does he feel bound by monetary orthodoxy. It is true, that inflation is a monetary phenomenon. However, that holds only in the long run. For the short term inflation is also determined by a couple of non-monetary variables. In addition, growth of monetary aggregates can be disturbed by special determinants such as portfolio effects. Therefore, there suitability as indicators may suffer.

As a consequence, the ECB-Council pursues a more broadly based approach. A second pillar is added. In monitoring the price developments and determinants the ECB-council judges the inflation expectations over the medium term.

For the euro-area financial markets, the introduction of the euro has had far-reaching implications. These include, in particular, the rapid convergence of the national markets to form a fully integrated euro money market, the strong growth in the market for euro-denominated corporate bonds as well as the wave of consolidation in the case of banks and stock exchanges. It has gradually become apparent, however, that a complete integration of the financial systems is currently still hindered by a large number of regulatory, tax and legal obstacles and eliminating those obstacles is proving to be complex and arduous. The Lamfalussy proposals are designed to accelerate that process.

III

Let me now turn to more practical aspects of the Monetary Union. European Monetary Union works. That is by no means a matter of course. The introduction of workable common instruments for monetary policy, the proper functioning of payment systems and the harmonisation of statistical methodologies are crucial to the success of the monetary union.

Most important among the technical aspects managed by the Eurosystem was, of course, the smooth introduction of euro banknotes and coins as sole legal tender. The 2002 cash changeover proved to be a formidable challenge for cash management and communication departments. The legacy currencies were withdrawn from about 300 million Europeans as well as from outside the euro area, where especially D-Mark was in circulation. At the same time, the new currency was issued.

To meet this challenge, a long and thorough preparation took place. The general framework for the changeover - including national changeover scenarios - was agreed at the European level as early as 1999 and 2000. Close collaboration with third parties - mainly banks, retailers and manufacturers of cash handling machines - was initiated at an early stage.

The withdrawal of national currency started in mid-2001. An award-winning campaign under the title “Don’t let sleeping coins lie”, the Bundesbank called upon the general public to hand in unused coins hidden in piggy banks, under pillows or among their socks. By November 2001, we had already collected more than 20% of all coins in circulation. Of course, a substantial amount of D-Mark is still in circulation. In comparison to December 2000 almost 4% of all D-Mark banknotes are in circulation. Some of it may never come back. However, the Bundesbank has committed itself to exchanging D-Mark banknotes for an indefinite period.

The logistical preparations for the introduction of euro banknotes and coins cash proved equally successful. In order to smooth the final changeover, the banks were supplied with notes and coins in advance (front-loading). The banks, in turn, provided retailers with the new cash - a process known as sub-frontloading. Of course, special debiting models had to be applied for the credit institutions in order to limit the costs they incurred in the changeover. In addition, a set of coins worth about 10 euro (starter kits) was sold to the general public around Christmas time in order to familiarise them with the new coins and provide them with the small change that they would need early in the new year.

Euro cash was put into circulation and change in euro was given from the very first few days of 2002 onwards. By 4 p.m. on 2 January, an average of 92% of automated teller machines had been converted to dispense euro notes across the 12 countries. Moreover, the new cash rapidly gained overwhelming acceptance. The old currencies were therefore withdrawn much more quickly than expected.This also led to an exceptionally high demand for low-denomination euro banknotes and coins and even caused some short-term bottlenecks.

Besides the logistical challenge, the changeover called for major efforts in communication. Every man and woman and child had to be familiarised with the new currency. That meant, at the very least, their denomination, appearance and security features. Equally, we were reluctant to make the security features known too early because of the potential threat of counterfeiting.

And indeed, we do have some indications that the euro as a leading currency is more subject to counterfeiters than the former national currencies of smaller countries. Hitherto, in Germany the number counterfeited euro banknotes is limited and lower than before. Therefore, the tremendous efforts to prevent counterfeiting proved worthwhile.

All major instruments of communication policy were used. The information campaign provided the general public with details of the new banknotes and coins. There was close cooperation with the press and the mass media.

Of course, the differing information needs of the general public and of professional cash handlers (banks, retailers) had be taken into consideration. Opinion leaders were informed and cash handlers were trained in working with the euro cash in advance. All accounting systems and each cash point had to be made ready for the new currency and the dual circulation period. As things turned out, the two-month dual circulation period was, if anything, too long.

The changeover had given rise to fears of inflation There were three main aspects to this. First, there was the possibility that businesses might try to recoup their changeover costs by putting up prices. Second, businesses might defer scheduled price increases until after the changeover owing to the need to display prices in the new currency. Third, price increases might occur owing to rounding differences. However, the changeover itself did not have a major impact on consumer prices. Many consumer goods were subject to automatic conversion since they are paid by standing order out of a bank account.

Nevertheless, even almost a year after the changeover, perceived inflation diverges significantly from the actual low rate of inflation. Consumers perceive inflation to be much higher and react accordingly. They attach greater importance to price developments in goods and services which they buy more frequently and pay for in cash. However, the harmonised indicator of consumer prices does cover a broad basket of goods. Higher perceived inflation occurred first in Germany but in the course of this year also in other member countries.

The Governing Council of the ECB keeps a close watch on the development of perceived inflation - not only because this is crucial to acceptance of the new currency but also because it may additionally have macroeconomic implications, such as matching rising wage demands.

All in all, the euro cash changeover is an outstanding example of the Eurosystem’s ability to cope with major challenges.

IV

At its last meeting, the ECB Governing Council discussed in depth the arguments for and against a cut in key interest rates. The rates were left unchanged, but we indicated that we would closely monitor the downside risks to economic growth in the euro area.

After a rather mild recession in 2001, economic growth picked up remarkably only in the US. In all other major economies, slight growth was mainly driven by external factors. Capacity adjustments - in particular in hi-tech businesses in major industrialised countries - are still taking place. Therefore, investment prospects look clouded.

The ongoing deflation in Japan is due to persistent structural problems in the banking sector. Recent announcements to reform the banking system have shed some light on possible solutions. As usual, however, it is harder to implement reforms than announce them. Japan, however, is benefiting a little from fairly strong growth in East Asian countries. Recent data may point at least to an end of recession during the ongoing fiscal year.

Among the emerging markets, East Asia and eastern Europe have performed better than again-crisis-ridden Latin America. The crises in Argentina and subsequently in Uruguay and Brazil have proved not to be as contagious as earlier emerging market crises. Financial markets are more aware of fundamental aspects nowadays. Contagion is more limited.

However, economic integration with the other side of the Atlantic seems to be closer than ever. The devastating effects of September 11 were by no means confined to the United States. We realised that there have been major repercussions in the European economy, even though trade and financial flows reacted with a time lag and not as strongly. This psychological transmission channel is much faster than trade flows or even financial investments. The worsening of the business climate in the US is having an impact on German investment.

In spite of high expectations early this year, the euro-area economy did not accelerate after the first quarter. Among the reasons for this are oil prices, the considerable turbulences on financial markets and the looming threat of a military conflict. Both factors continue to be among the downside risks to the economy.

Nevertheless, the ECB Governing Council expects growth rates to pick up and to return to potential in the course of 2003. Private consumption might benefit from rising real income due to lower inflation rates. Investment activity is supported by the low level of interest rates and a possible stabilisation on the financial markets. And improvements in the world economy as well as faster trade growth will foster export development.

The present annual inflation rate, 2.2% is very close to the mark for stability. Most likely developments indicate a declining rate in the first half of next year. Of course, upward risks to prices are always present. Most important among these are oil prices and labour costs. At the most recent meeting of the Governing Council, price risks were judged to be balanced. However, the described growth scenario is subject to a great deal of uncertainty. The risks to the economy tend to be - I am sorry to say - on the downside.

V

The outlook for European Monetary Union in the medium term depends first and foremost on the enlargement process and the union's ability to cope with it. The ongoing enlargement of the European Union and joining EMU represent the most important challenge.

The accession of the candidate countries in central and eastern Europe is a major item on the agenda. EU accession is decided on the basis of the criteria adopted at the Copenhagen European Council.

Monetary union is the final stage in a process of evolution. In principle, all the Maastricht criteria, including the exchange rate criterion, have to be met before a country can join the Eurosystem. Country-specific exceptions must not be allowed to set a precedent. At most, exchange rate arrangements based on currency boards could potentially be considered equivalent to ERM II.

For accession countries to join monetary union, they need to catch up by striving for real and nominal convergence. The past few years have already seen significant progress towards real and nominal convergence. However, each individual accession country's situation must be judged separately. Some countries already have a level of prosperity and convergence that is close to the EU average.

Cases in point are Cyprus and Slovenia. Per capita GDP, expressed in purchasing power parities, is 85% of the EU average in Cyprus and 69% in Slovenia. Those two countries generate a higher per capita GDP than some EU countries. Some of the remaining accession countries lag considerably further behind. When looking at the averages, it should not be forgotten that, in some cases, there are major regional disparities within EU countries and accession countries.

In real economic terms, the accession of central and east European countries is already a fact of life. Between 1993 and 2000 the share of accession countries' total exports going to the EU rose to two third. Sixty per cent of imports come from the EU.

The integration of central and east European countries has been made easier by progress in capital market liberalisation. Positive macroeconomic data and the prospect of EU accession have been leading to large-scale direct investment. Since 1999, direct investment has accounted for around 5% of all accession countries' GDP.

The heterogeneous nature of monetary union will increase along with enlargement - labour and goods markets therefore need flexible adjustment mechanisms. The single monetary policy is a catalyst for reforms in other policy areas. The nation states are in competition with one another to find the best solutions for economic, labour market and fiscal policies. Successful policy solutions set a benchmark for the less successful countries.

Besides the economic criteria for a successful monetary union, the European System of Central Banks should be reformed to cope with enlargement. The present structures were designed for a 15-member monetary union. Reform should take account of the fact that, in a few years' time, the EU could comprise as many as 27 members. Reform must therefore be designed to take account not just of the current round of enlargement, in which up to ten nations will join the EU.

Let me conclude by making some comments on your debate about possible EMU membership. The ECB Governing Council is well aware of the ongoing public discussion in your country. Sweden would be very welcome in the monetary union. More than that, for Sweden - neighbouring Finland and across the Baltic Sea from Germany - EMU membership should be a natural choice. In macroeconomic terms, membership would be of mutual benefit. The Swedish business cycle moves in notably close harmony with the euro area. Inflation, inflation expectations and long-term interest rates are closely correlated.

At the core of the debate in your country lies the concern about the threat of an asymmetric shock. To my mind, the Eurosystem has demonstrated its capacity to cope well with economic shocks. In addition, strong asymmetric shocks are increasingly rare in times of ongoing economic integration. The possibility of major asymmetric shocks declines with the rising importance of trade, foreign direct investment and capital market integration.

Swedish banks have already shown a greater inclination to invest on foreign markets. They are, to some extent, among the leaders in terms of European integration. To sum up: economic and financial integration is deepening within the monetary union and even with the other side of the Atlantic. Therefore, the built-in-stabilisers and the cushioning effects of the integrated European markets provide the shelter needed - for your country as well - to cope with asymmetric shocks.

Sweden's EMU membership is in your and our interests. I hope that very soon, on another visit to your beautiful country, I shall be able to use the same currency that I do in Rome, Paris or Frankfurt.