

Christian Noyer: The euro, a stabilising factor at home and abroad

Speech by Mr Christian Noyer, Governor of the Bank of France, at "Paris Europlace" a financial meeting in Hong Kong, 21 March 2005.

* * *

Introduction

- The legal basis for the single monetary policy is the Treaty on the European Community, whose Article 105 states that "the primary objective of the European System of Central Banks shall be to maintain price stability".
- Price stability, combined with the convergence of euro area economies, is the key issue enabling the euro to become a stable international currency.
- Thanks to a strong macroeconomic framework and to the convergence of euro area economies, the introduction of the euro has limited the risks of disequilibrium inside the euro area (Part 1). Furthermore, the international role of the euro as a vector of stability has increased (Part 2).

Part 1: The euro has been a key factor for maintaining stability inside the euro area

The efficient macroeconomic framework of the euro area (A) has made the economies of the euro area more homogeneous and reduced the risks of macroeconomic disequilibrium (B). As a result, the euro area is characterized by strong economic fundamentals (C).

A *The macroeconomic framework of the euro area is an efficient framework*

- For the past six years, the Eurosystem has been responsible for defining and implementing the single monetary policy. The primary objective of the Eurosystem is to maintain price stability, which has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% in the medium-term. In May 2003, the ECB Governing Council confirmed this definition and specified that, in the pursuit of price stability, it will aim to maintain inflation rates close to, but below, 2% over the medium-term. The **monetary policy** conducted by the Eurosystem has led to a low level of inflation, which averaged 2% between 1999 and 2004, and to very favorable financing conditions as both short-term and long-term interest rates have reached very low levels.
- Moreover, in principle, fiscal policies cannot undermine the objective of price stability as the Treaty prohibits monetary financing and as Member States are committed to implementing the Stability and Growth Pact. However, the lack of fiscal discipline in some euro area countries and the recent debate at the EU level have illustrated the fact that it is still necessary to enhance the efficiency of the **European fiscal framework** and, especially, to strengthen the preventive arm of the Stability and Growth Pact, which deals with the surveillance of budgetary positions. The fiscal framework enshrined in the Treaty on European Union and in the Stability and Growth Pact is a cornerstone of Economic and Monetary Union and, thus, of central importance to the cohesion of Monetary Union itself.

B *The introduction of the euro has increased the homogeneity of European economies and limited the risks of macroeconomic disequilibrium inside the euro area*

The convergence process, the homogeneity of European economies and the synchronization of business cycles have increased since the introduction of the euro

- **Regarding business cycles**, some recent work presented by a working group joining the CEPR (Centre for Economic Policy Research) and the Eurosystem shows that the correlation between business cycles as a whole and also consumption and investment in most euro area countries has increased since 1999. A common European component seems to play a more important role in these economies than the national components do. The

degree of correlation between national cycles and the euro area aggregated cycle varies between 0.70 and 0.92.

- **Concerning inflation**, the research conducted by the Eurosystem shows that the degree of dispersion of inflation rates inside the euro area is not significantly superior to that observed in the USA, where the federal budget and the much more unified market of goods and services constitute additional room for manoeuvre. The standard error of the annual growth of prices in the 12 euro area countries is in the vicinity of 1.1, compared with 0.8 in the 14 regions of the USA.
- Finally, the updating of the vast work on **monetary transmission mechanisms** led by the Eurosystem shows that Member States' economies are more homogeneous as regards the transmission of monetary impulses since the introduction of the euro.

The EMU has limited the risks of exchange rate crises and catalyzed the financial integration of the euro area economy

- **The euro has put an end to the potential effects of exchange rate crises and favoured the emergence of a stable environment characterized by historically low interest rates.** Thanks to these developments, the euro area countries have not been confronted with difficulties stemming from the uncertainties due to recent geopolitical troubles.
- **The introduction of the euro has catalyzed the financial integration of the European economy**, which is totally complete as regards the money market. In the first weeks following the introduction of the euro, price differences on national interbank money markets decreased very quickly to stand at less than 5 bp. This level corresponds to the spread bid-ask currently observed on the market.
- **A comparable movement has occurred on European bond markets**, where returns on government yields have converged.
- **The euro area, and more broadly the European Union, now have a consistent financial architecture.** The implementation of the Financial Services Action Plan defined at the Lisbon European Council is on the way to completion. Subsequently, the Lamfalussy process should provide a new institutional architecture in the fields of financial supervision and regulation and develop flexible and uniform technical rules.

Part 2: The euro plays the role of an international currency and a nominal anchor

The available data bear out the increase in the international role of the euro. At the regional level, it plays a significant role as an anchor and is the vector of a culture of stability. The increasing role of the euro at the international level is due to the development of its use as a financial instrument and as a medium of exchange (A) and of its role as an anchor for exchange rate regimes (B).

A The euro is an essential financial instrument and a key medium of exchange

- **The use of the euro as a financing and an investment currency on the capital markets has increased.** In the first half of 2004, the euro accounted for almost 36% of the gross issuance of long-term international debt securities, compared with 24% in 2002. The share of the US dollar was down from almost 50% in 2002 to 39%.
- Another significant development is **the emergence of a corporate bond market in the euro area**, whose volume has increased significantly in the last few years. The outstanding amount of quoted shares issued by euro area residents was EUR 4,035 billion in 2004 as against EUR 3,118 billion in 2002.
- **As a settlement currency, the role of the euro is expanding.** In 2003, between 50% and 60% of goods and services traded between the euro area countries and the rest of the world were settled in euro. This is true for both exports and imports. In countries where the use of the euro as a medium of exchange is highly significant, such as the Central and Eastern European Countries, 60% to 80% of exports and imports were settled in euro.

B *The euro contributes to the stabilization of exchange rate regimes and financial systems*

The euro is an instrument for the diversification of foreign exchange reserves

- According to the latest available data from the Bank for International Settlements (BIS), **the euro is the second reserve currency after the US dollar** (19.7% of the total amount in 2003 compared with 63.8% for the dollar) but the share of the euro has increased significantly (it stood at 12.6% in 1999). This is an important factor of protection for many countries with regard to strong exchange rate fluctuations because it allows public investors to diversify their reserves assets. Moreover, it constitutes a stabilizing factor for the international monetary and financial system as a whole.

The euro is a factor of stability for exchange rate regimes

- In 52 countries or territories, **the euro serves as the anchor of exchange rate policies or as the sole reference currency or as part of a currency basket**. This mainly concerns the countries that have trade or institutional arrangements with the euro area (acceding countries, accession countries, the Balkans, North Africa and the Franc zone). These exchange rate regimes are the result of unilateral decisions that do not involve the Eurosystem. Nevertheless, these strong links could import credibility into these countries, so long as they pursue appropriate policies at the same time.

Conclusion

- In contrast to the domestic role of a currency, which is strongly determined by institutions, the international role of a currency is market driven. This explains why the different uses of money proceed at different speeds.
- The fact that many countries outside the euro area have rapidly decided to link their exchange rate regimes to the euro illustrates the fact that they consider the euro to be an international factor of stability due to the stabilizing role it has played and still plays in the euro area.