Jean-Claude Trichet: Two successes of the euro - the single monetary policy and European financial integration

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Conference on experience with and preparations for the euro, organised by the Austrian National Bank (Oesterreichische Nationalbank) and the Austrian Federal Economic Chamber together with the Austrian Federal Ministry of Finance and the European Commission, Linz, 11 May 2006.

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Introduction

Ladies and gentlemen,

I would like to start by thanking the Oesterreichische Nationalbank and its co-hosts for inviting me to speak today at your conference session entitled “Experience with and preparations for the euro”. This year, the euro is in its eighth year, and serves as a single currency for more than 300 million citizens.

I would like to address two successes of the euro which are particularly relevant to the ECB’s responsibilities: the single monetary policy and the progress in European financial integration, for which the euro has acted as a major catalyst.

First, I will discuss some of the key successes achieved by the single monetary policy over the seven and a half years since the introduction of the euro in January 1999. Above all, the single monetary policy has served to anchor longer-term inflation expectations securely at levels in line with our definition of price stability. This anchoring has facilitated the preservation of price stability, which is a prerequisite for sustainable economic growth and employment creation in the euro area.

I would then like to share with you some thoughts regarding the progress in European financial integration that has been witnessed in particular since the introduction of the euro. My basic assessment is that the overall pace of integration has been impressive. And while the euro generally acted as a major catalyst for the integration of all the financial markets, integration is more advanced in those market segments that are closer to the single monetary policy – above all the money market.

The single monetary policy

The introduction of the euro on 1 January 1999 was an event of the greatest historical, institutional and economic significance. Seven and a half years on, we can take stock of the considerable successes achieved by the euro, successes of which the European Central Bank (ECB) is justifiably proud. More importantly, when seeking to perpetuate these successes and, as the euro area enlarges, to extend them to others, we must identify the key principles on which the successes of the single monetary policy rely.

To manage the new currency, the ECB created a strategy for the conduct of a single, stability-oriented monetary policy for the entire euro area. In line with its Treaty mandate to maintain price stability, the ECB pursues this strategy so as to keep annual consumer price inflation at rates below, but close to, 2% over the medium term. This definition of price stability preserves full continuity with the earlier core definitions of the national central banks. Furthermore, the process of transition towards the single currency was based upon convergence towards the best performers and not convergence towards an average of the various countries’ performances. As a result, the ECB and the euro inherited the high level of credibility achieved by the most stable national currencies.

Looking back over the period since the euro was launched, euro area inflation has indeed been very close to 2% on average. Moreover, longer-term inflation expectations have remained securely anchored at levels consistent with the ECB’s definition of price stability. Monetary policy in the euro area has thus proved successful in maintaining stable prices and building the public’s confidence in its ability to continue to do so. Through this achievement, the single monetary policy makes its best possible contribution to supporting sustained growth in economic activity and employment creation. Along the way, stability-oriented policies have also directly improved the well-being of households, inter alia, by supporting the purchasing power of their income and savings.

Three key principles have been of paramount importance to the success of the single monetary policy: independence, transparency and credibility.

First, it is widely recognised that delegating the conduct of monetary policy to an independent central bank with a clearly defined mandate to maintain stable prices is a necessary condition for success. Both theoretical literature and empirical research demonstrate that this is the best institutional structure to ensure consistency in the design and conduct of monetary policy over time and thus to achieve the socially desired objective of price stability. Reflecting this, the Maastricht Treaty granted the ECB total independence in the pursuit of price stability. This independence has and will continue to serve the ECB and the European public well.

Second, institutional independence is necessarily accompanied with transparency and accountability. An independent institution is, at last resort, accountable to the general public in a modern democracy. Transparency also improves the public's understanding of how the ECB conducts monetary policy, thereby fostering a better understanding of its objective and improving the predictability of its decisions, both factors that help to make monetary policy much more effective -- actually, several studies and research papers have shown that the ECB is among the most predictable central banks in the world. In the interests of transparency, we regularly explain our policy framework and actions to the people of Europe, their elected representatives – namely the European Parliament – professionals in the financial markets and the media. Indeed, the ECB was the first major central bank to introduce a public display of its diagnosis and overall assessment immediately after the meetings of the Governing Council via a regular monthly press conference immediately after the announcement of its monetary policy decisions.

Credibility is the third principle that I would like to emphasise as underlying the success of the single monetary policy. A high degree of credibility is essential to the ability of a central bank to guide expectations about future inflation and interest rates. In a market-based economy, the central bank can directly influence short-term interest rates through its monetary policy instruments. Consumption and investment decisions, and thus medium-term price developments, are also to a large extent influenced by longer-term interest rates, which depend largely on private expectations regarding future central bank decisions and future inflation. It is important that developments in longer-term rates support the objective of maintaining price stability over the medium term.

How do these three elements come together to contribute to the successful conduct of monetary policy for the euro area? Let me illustrate by using an example from our recent experience. Over the past few years, the euro area has witnessed a gradual recovery in economic activity that has now led to real GDP growth rates that are close to our present estimates of the potential growth rate of the euro area economy. However, over the same time period headline annual HICP inflation in the euro area has remained at rates just above 2%, mainly as a result of the strong increases in energy prices. Indeed, oil prices have surged from around USD 30 per barrel at the beginning of 2004 to an average of USD 71 per barrel in April 2006. In the past, prior to the single monetary policy, such large increases in energy prices led to substantial lasting rises in headline inflation stemming largely from second-round effects in wage and price-setting behaviour, which have their origin in a dis-anchoring of inflation expectations. In the most recent period, such second-round effects have not emerged.

Indeed, one of the successes of the single monetary policy in the recent past has been the effective anchoring of inflation expectations at levels consistent with price stability, despite the surge in oil prices and a number of other inflationary shocks. All available measures of long-term inflation expectations consistently point to expectations of continued low and stable inflation. For example, the latest ECB Survey of Professional Forecasters (SPF) for the second quarter of 2006 indicates that expectations of private forecasters for inflation five years ahead have remained remarkably stable at 1.8-1.9% since the survey began in the first quarter of 1999.[1] Break-even inflation rates calculated from nominal and inflation-linked bonds give a broadly similar picture: longer-term implied forward break-even rates have remained broadly stable close to 2 % in the course of 2005 and early 2006, despite oil price increases. This does not mean that we can be complacent in any respect. It is our own constant credible alertness which is contributing to this solid anchoring.

[1] The ECB's Survey of Professional Forecasters is a quarterly survey of private sector forecasters that provides information about expectations for the rates of inflation in the euro area for several horizons, together with a quantitative assessment of the uncertainty surrounding these expectations. Additional information can be found in J. A. Garcia "An introduction to the ECB's Survey of Professional Forecasters", ECB Occasional Paper No 8, 2003.

Indeed the effectiveness of the ECB's anchoring of longer-term inflation expectations follows from its high credibility with regard to countering inflation risks coming in particular from oil price increases that could emerge via second-round effects in price and wage-setting. In this context, transparent and clear communication has increased the public's understanding of the likely ECB reaction to price pressures stemming from increases in oil prices. As a consequence, the firm anchoring of inflation expectations, among other factors, has contributed to enhancing the resilience of economic activity to oil price shocks during the recent recovery.

However, success in the past gives no reason for complacency: in the future as in the past, the ECB will continue to act promptly, where necessary, to contain risks to price stability over the medium term.

Remaining alert has been at the heart of our conduct of monetary policy. Inflation projections were progressively revised upwards in the course of 2005, mainly – but not only – reflecting further upside surprises in oil prices. Furthermore, as the year progressed, upside risks to medium-term price stability were identified in our economic analysis and confirmed by the monetary analysis in the context of strong monetary growth, ample liquidity and rapid expansion of credit. That is the reason why I expressed, in the name of the Governing Council of the ECB, the need for increased vigilance with respect to upside risks to price stability at the beginning of October 2005. By the end of 2005, the regular cross-checking of the economic and monetary analyses indicated that an adjustment of the very accommodative stance of the ECB's monetary policy was warranted to address these risks. Therefore, the Governing Council decided to increase the key ECB interest rates by 25 basis points, first on 1 December 2005 and then again on 2 March 2006.

Interest rates are still at very low levels in both nominal and real terms. Short-term real interest rates (such as the three-month EURIBOR deflated by current HICP inflation) have increased to reach positive levels over the past few months, but remain close to their lowest levels in decades. Our monetary policy thus remains accommodative. As I said in my last press conference, to safeguard the successes of the past, the Governing Council is in a position of strong vigilance to ensure that risks to price stability do not materialise, thereby making an ongoing contribution to sustainable economic growth and job creation in the euro area.

The single monetary policy has proved successful in anchoring inflation expectations in the turbulent context of recent quarters. However, it is important to remember that the single currency and the single monetary policy for the euro area are very long-term projects. Many benefits stemming from the single currency are of a structural nature and will become even more obvious over a longer period of time. Moreover, the achievements of the single monetary policy should not be seen in isolation from the broader process of economic integration in Europe. The introduction of the euro has helped to consolidate the tremendous gains derived from European economic integration over past decades. I also strongly believe that the euro is and will continue to be a key catalyst for further integration. Nowhere is this more apparent than in the financial domain.

European financial integration

I now turn to my second theme, namely the process of European financial integration. I will address both the progress of financial integration over the past seven years since the introduction of the euro and also some challenges that lie ahead.

The euro's success: its performance with respect to European financial integration

To start, I would like to recall why progress in European financial integration is seen to be highly positive. From the Eurosystem's perspective, we generally distinguish four main benefits arising from financial integration. First, financial integration is of key importance for the conduct of the single monetary policy, as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. Second, financial integration is highly relevant to the Eurosystem's task of contributing to safeguarding financial stability. Third, financial integration is fundamental both to the Eurosystem's task of promoting the smooth operation of payment systems and to its strong interest in the safe and efficient functioning of securities clearing and settlement systems. Finally, it is generally accepted that financial integration fosters financial development and the modernisation of the financial system and, ultimately, contributes to increasing the potential for stronger non-inflationary economic growth.

Many factors have contributed in the recent past to enhancing financial integration in Europe. First, public action at the Community level aims to remove residual legislative and regulatory obstacles as well as to allow competitive forces to deploy their effects in full. Second, the introduction of the euro has removed a major hindrance to financial integration, notably foreign exchange risk. Third, market participants have to a certain extent exploited the new environment by increasing their cross-border activities. The ensuing question is how can the euro's contribution and performance in this respect be measured? I suggest two measures of performance.

The first and most obvious way of measuring performance is to look at the "hard facts". As discussions on this topic are often of a qualitative nature, stating the general need to enhance European financial integration in view of the related benefits, the ECB has sought to devise a way to capture, in quantitative terms, the state of financial integration in the euro area. Such quantitative measures, mainly based on the law of one price – which states that assets with identical risks and return characteristics should be priced identically regardless of where they are transacted – offer the advantage of being able to illustrate both the current level of financial integration and its evolution over time, i.e. whether integration is progressing, stable or even regressing. The ECB therefore published last year a first set of quantitative indicators regarding the state of integration of euro area financial and banking markets, together with an explanatory report. With this publication, the ECB has started to regularly measure and monitor progress in euro area financial integration.[2]

The broad finding of this analysis is that the euro has generally acted as a major catalyst for the integration of all the financial markets. The degree of integration differs between market segments and integration is more advanced in those market segments that are closer to the single monetary policy, above all the money market. Let me mention some specific results.

The unsecured euro interbank deposit market was almost perfectly integrated right at the start of 1999. The cross-country standard deviation of the average overnight lending rates among euro area countries was as low as 3 basis points in early 1999 and has since decreased to just 1 basis point. For comparison purposes, let me mention that in January 1998, i.e. one year before the start of Monetary Union, the cross-country standard deviation was still higher than 130 basis points. A similar picture is provided for the one-month and twelve-month maturities, with the respective cross-country standard deviation of EURIBOR lending rates among euro area countries standing, since early 1999, at values normally below 1 basis point. Finally, the euro area cross-country standard deviation of the one-month EUREPO rates has generally been below 1 basis point and that for the twelve-month maturity has been below 2 basis points since the launch of the EUREPO index in 2002.

The decisive role of the euro in enhancing financial market integration is also visible in the interest rate derivatives markets. A particularly important segment is the euro interest rate swap market, which is now the largest interest rate swap market in the world: with a daily turnover of around €250 billion, the euro interest rate swap market is about one half larger than the equivalent US dollar segment that has a daily turnover of around €160 billion (see the BIS Triennial Central Bank Survey, March 2005). A relevant part of the euro interest rate swap market is the euro overnight index swap market. Here, the launch of the EONIA Swap Index in June 2005 is evidence of both its importance and further potential.

Government bond markets have also achieved a very high degree of integration, mainly due to the disappearance of intra-euro area exchange rate risk and the convergence of inflation expectations across countries by the time the euro was introduced. Since then, government bond yields have been driven mainly by euro area-wide factors – notwithstanding the fact that remaining differences between countries may also still be explained by differences in liquidity and perceived credit risk.

Our indicators for the state of integration of the euro corporate bond market are based on econometric models and suggest that this market segment is fairly integrated in the sense that the country of issuance is only of marginal importance in explaining yield differentials.

Finally, with respect to the euro area equity market, our indicators show that the elimination of intra-euro area currency risk has encouraged integration in that the "home bias" in the equity holdings of institutional investors has been significantly reduced as the importance of sector versus country-based investment strategies has increased.

[2] See the ECB's website at http://www.ecb.int/stats/finint/html/index.en.html, last update April 2006.

As a second measure of the euro's success in fostering financial integration, I would like to mention the work of "the institutions behind the euro", namely the ECB and the whole Eurosystem, which provide numerous contributions to European financial integration.

Overall, we are of the view that financial integration is first and foremost a market-driven process. In addition to this, we see it as a basic task of public authorities to create a framework that is conducive to fostering financial integration.

In this respect, the ECB has defined four kinds of activity with which the ECB and the Eurosystem contribute to this process: (1) we try to enhance knowledge and raise awareness of the state of and need for European financial integration, and we measure the progress made – the most obvious example in this respect is the launch of our regular monitoring on the basis of quantitative indicators of financial integration in the euro area, which I mentioned earlier; (2) we act as a catalyst for private sector activities by facilitating collective action and assisting with possible coordination problems; (3) we provide central banking services that also foster European financial integration; and (4) we provide advice on the legislative and regulatory framework for the European financial system. Let me now also give some concrete examples of the latter three kinds of activity.

We can assume the crucial role of acting as a catalyst for market participants' activities due to the fact that the ECB, and the whole Eurosystem, is in the unique institutional position of being both a public authority with a pan-European remit and, as a result of its basic tasks as a central bank, itself an active participant in the market. As a very recent example in this respect, I would like to highlight the Short-Term European Paper – or STEP – initiative, led by ACI – the Financial Markets Association and the European Banking Federation. This initiative aims to promote the further integration of the European short-term securities market via the convergence of standards and practices through market participants' compliance with the STEP Market Convention. In the coming days, Euribor ACI and Euribor FBE will formally adopt the STEP Market Convention. Issuers will then be able to apply for the STEP label. The information memoranda of the first STEP-labelled programmes are available on the STEP Market website as of this month. The Eurosystem has supported this initiative since its inception, It provides technical support for the labelling process for the first two years, and the ECB produces statistics on yields and volumes in the STEP market which it publishes on the its website. These statistics are expected to play an important role in fostering the integration of the European short-term securities markets through greater market transparency.

Concerning the provision of central banking services that also foster European financial integration I mention the most prominent example: our operation of the real-time gross settlement payment system for the euro, the TARGET system. In fact, the rapid integration of the euro money market, which is a sine qua non for monetary policy implementation, has been supported by the establishment of the TARGET system, which has been operational since the very start of Monetary Union. The launch of the single shared platform, TARGET2, scheduled for end-2007, will further enhance financial integration, as it will provide a harmonised level of service and a single price structure for domestic and cross-border payments.

I turn finally to the last kind of contribution, namely the provision of advice on the legislative and regulatory framework for the European financial system. The Eurosystem regularly contributes in numerous areas related to EU financial services policy and financial regulation. In particular, it contributed to the European Commission's public consultation regarding the priorities for financial services policies over the next five years. This consultation led the European Commission to publish, in December 2005, its "White Paper on Financial Services Policy 2005-2010". Particular focus has been placed on, among other things, the further integration of retail banking services and of the financial infrastructure, including both securities clearing and settlement systems and payment systems. This brings me to the challenges ahead with respect to European financial integration.

The challenges ahead with respect to European financial integration

Under the heading "success", I have described the progress of integration in the main financial market segments. Now, regarding the "challenges for the future", it remains for me to mention those parts of the European financial system where integration is lagging behind most, i.e. the retail banking markets and the financial infrastructure, as has also been pointed out in the Commission's White Paper.

Integration in retail banking has not progressed to any great extent. For example, our published indicators reveal marked differences between individual euro area countries' interest rates on loans to households for consumption. Other financial products, such as loans to households for house purchase, also show a significant cross-country standard deviation among the euro area countries. Obviously, further progress in retail banking integration is very much warranted.

The same – I would say unsatisfactory – situation holds for the retail financial infrastructure. By contrast with the developments in large-scale payment systems, the situation for retail payments today is nearly unchanged as compared with that prevailing before Monetary Union: in 2005 there were still 15 different retail payment systems within the euro area, compared with 20 in 1998. The banking industry has, however, launched an initiative to create a Single Euro Payments Area (SEPA), which will enable European citizens, enterprises and public authorities to make payments throughout the euro area from a single bank account, using a single set of payment instruments, as easily and safely as in the national context today. In addition, national infrastructures will be migrated to a pan-European payments infrastructure characterised by complete interoperability between SEPA-compliant infrastructures. Sizeable financial benefits are expected from the integration of retail payment systems, as a result of standardisation and the opening-up of payment services markets to more competition.

I would like to stress that this initiative is a very promising signal. The ECB and the whole Eurosystem also support this initiative by acting as a catalyst where high-level coordination takes place with the banking industry and meetings involving SEPA end-users. Let me underline in particular the following points which the Governing Council of the ECB approved recently and where we are in full agreement with the Commission:

- The Commission and the ECB see SEPA as an integrated market for payment services which is subject to effective competition and where there is no distinction between cross-border and national payments within the euro area.
- The introduction of the euro as the single currency of the euro area will only be completed when SEPA has become a reality, i.e. when consumers, business and governments are able to make cashless payments throughout the euro area from a single payment account anywhere in the euro area using a single set of payment instruments as easily, efficiently and safely as they can make payments today in the domestic market.
- By creating open and common standards that overcome technical and commercial barriers and by fostering effective competition, improved payment service levels will benefit the end-users of these services, namely consumers, business and governments, with transparent prices and cost efficient services.

Conclusions

Ladies and gentlemen, let me conclude:

The single monetary policy – firmly rooted in the principles of independence, transparency and high credibility – has been remarkably successful in anchoring longer-term inflation expectations at levels consistent with price stability. Through this achievement, the single monetary policy has preserved a necessary condition for sustained growth in economic activity and employment creation. As I said in my last press conference the Governing Council is in a position of strong vigilance to ensure that risks to price stability over the medium term do not materialise. Our credible alertness will be as effective in the future as it has been in the past.

Financial integration enhances the smooth and effective transmission of monetary policy impulses throughout the euro area and, via its effects on financial development and modernisation, ultimately contributes to increasing the euro area potential for stronger lasting non-inflationary economic growth. The ECB and the whole Eurosystem, for their part, will continue to provide their contributions in this respect, as they have successfully done over the past seven and a half years.

I thank you for your attention.