Lorenzo Bini Smaghi: The international role of the euro and its potential in Latin America

Keynote speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the conference "The Euro: Global Implications and Relevance for Latin America", São Paulo, 17-18 March 2008.

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Ladies and Gentlemen,

During our lunch I would like to share with you some brief reflections on the international dimension of Europe's Economic and Monetary Union, or EMU. The title of my presentation has an additional part: "and its potential for Latin America". I am not sure that I should be the one to assess the potential for the euro in Latin America; I should perhaps let a Latin American audience decide for itself. As you know, the policy of the ECB is neither to encourage nor to discourage the use of the euro.

What I would prefer to do today is to examine the main lessons that can be drawn from the ten years of experience with Monetary Union, lessons that may also be of interest for the rest of the world, in particular Latin America. I will be very concise and selective, given the time constraints. I will thus focus on the main issues that I think deserve some attention and will inevitably leave aside important aspects that may be taken up later in the discussion.

I will focus on five main lessons that I would draw from the first ten years of the euro and discuss a few issues that are currently being debated in Europe and may be of relevance to Latin America, in particular for its policy-makers. Let me start with the lessons.

The first lesson that can be drawn from the last ten years is the importance for an economy like the euro area of having its own monetary policy. This seems self-evident, but it is not always the case. We currently see around the world many important countries and economies that have actually chosen not to have their own monetary policy. Consider for instance the case of China, other Asian emerging markets, the Gulf countries, or Russia. By making the exchange rate the main target for their policies they have de facto given up their monetary policy and have imported monetary conditions prevailing in the country whose currency they are targeting, most often the United States. Given that underlying economic conditions in the United States will surely be different from those prevailing in these other countries, the monetary conditions that the latter will import are unlikely to be the most conducive to sustainable growth. Giving up the ability to conduct monetary policy is bound sooner or later to give rise to internal instability. Just as an illustration, an economy growing at 10% per year with inflation rising towards 10% cannot afford nominal interest rates of 5%, even less 3 or 2%. We now know the problems that low interest rates for a protracted period of time can produce.

Ten years of EMU suggest that it is possible – it is actually desirable – for the major economies of the world to have their own monetary policy, attuned to their internal conditions and targeted at domestic objectives.

This first lesson doesn't seem to be wholly understood by all observers. In particular, some financial market participants and commentators are at times led to think that central banks are more or less bound to act in a similar way. In fact, in the last few months the various central banks have acted quite differently, precisely because of the different situations prevailing in their respective economies. Some have decreased rates, others have kept their rates unchanged and others have actually increased rates. The world economy is becoming more integrated but at the same time also more affected by idiosyncratic shocks and diverging starting conditions, which may at times require different responses from the policy-makers around the world.

The second lesson is that price stability should be the primary objective of monetary policy. This is now enshrined in the statutes of most central banks around the world, with the exception of the Federal Reserve System, whose mandate goes back to the end of the 1970s.

Ten years of experience of EMU show that price stability can be ensured without sacrificing growth over the medium term. Comparing the last ten years with the ten years before EMU, we see that inflation has been lower, while growth has been broadly similar and employment growth, lately, much stronger. I will not dwell too much on this issue. It seems to me that recent developments confirm that having a clear primary objective, which is also well-defined in quantitative terms, is the best way to anchor market expectations and to ensure a smoother adjustment to external shocks, of a real or financial nature.

The third lesson is that an independent central bank is essential to ensuring that the first two requirements I have just mentioned are met. It strengthens the credibility of monetary policy aimed at price stability and therefore enables relatively lower interest rates to be maintained.

Central bank independence has many elements; the personal and institutional aspects are two of the most important. If monetary policy is to be conducted with a view to the medium term, rather than in reaction to very short-term developments, security of tenure for a relatively long time – in the case of the ECB's Executive Board, for instance, the non-renewable term is eight years – is quite relevant. It helps the decision-makers to set monetary policy independently of the political cycle.[1]

In theory, central bank independence tends to be taken for granted. In practice, as the European experience shows, it may be challenged even when the statutes of the central bank are enshrined in a constitutional framework. The support of the people for the independence of the central bank and for the objective of price stability is additional protection against any attempt to undermine independence. In all the countries of the euro area, the support of public opinion for these two things is very strong.

The fourth lesson is that clarity about the role of monetary policy also helps to clarify the role of other policies, in particular fiscal and structural policy.

With respect to fiscal policy, there is now a consensus that fiscal discipline is essential, not only in a monetary union but also in individual countries, to ensure room for manoeuvre for an anticyclical budget, be it discretionary or automatic. The Stability and Growth Pact and the 3% and 60% limits on a country's deficit and debt in the Treaty establishing the European Community have now also found a broad application in macroeconomic surveillance in other continents.

Experience shows that countries that have complied with the requirements of the Pact, in particular by maintaining a sound budgetary position in good times, have a wider margin to absorb the negative effects of an economic slowdown. Those countries which instead delay the adjustment are certain to face the next slowdown with much greater anxiety, with negative effects on consumer and investor confidence.

The main instrument for enhancing long-term economic growth and employment is structural policy. This has become universally recognised in the EU. The Lisbon process enables structural policies and their results across countries to be compared, on the basis of a simple set of indicators. This has the advantage of focusing discussions within the individual countries on policies that are necessary for growth.

Some results have been achieved. For instance, the structural rate of unemployment has decreased substantially in most countries, following labour market reforms. Overall, some 13

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[1] See L. Bini Smaghi (2008): "Central Bank Independence in the EU: From Theory to Practice", European Law Journal, forthcoming.

million jobs have been created since the introduction of the euro, against less than 3 million in the previous decade. However, much needs to be done in the labour and product markets, especially in the services sector, to permanently increase productivity in the euro area.

Overall, it can easily be seen in Europe that the countries which have implemented the most far reaching reforms have also performed better over the years. A similar comparison in other countries or areas of the world could help to clarify the responsibilities of the various policies in achieving sustainable growth.

The last lesson that I would like to draw to your attention is that EMU in Europe is much more than a monetary union, it's in fact a political union. The sharing of the same currency has implications for citizens that go beyond what we as economists are used to considering. It entails implicit contractual relations which have a direct impact on citizens' day-to-day decisions. Furthermore, policy-making structures in the euro area have become much more intertwined not only in relation to monetary policy but also to budgetary policy.

This issue would require much more time to discuss in detail and is not always fully understood, partly because the form that political union has taken in the euro area, and in the EU more generally, is quite unique, evolving over time in a way that does not correspond to other political unions around the world. To be sure, the issue has not been understood by those observers, in particular in the financial markets, who consider leaving the euro area a viable policy option. As Barry Eichengreen recently showed in a paper, the way the euro area has been constructed and developed means that any exit would entail not only economic but also political consequences so as to make it nearly impossible.[2] The fact that the United Kingdom, Sweden and Denmark will enter the euro area only when their people agree to such a decision is further confirmation that EMU is indeed a political union.

The five lessons that I have mentioned help to explain why the euro has emerged as the second world currency in just about ten years. I will not provide you with the data illustrating these developments. They can be obtained from the regular ECB publication on the international role of the euro.[3]

The developments of the last ten years provide us not only with lessons but also with issues that remain open and pose challenges to policy-makers. Let me illustrate three.

A first issue concerns the impact that a new international currency has on the functioning, and in particular the stability, of the international financial system. This is an issue on which the literature has so far said very little. In theory, one could think that a world with several reserve currencies would be more stable, because it would confer more opportunities on international investors and would impose greater discipline on policy-makers. However, recent events tend to confirm that relying on markets alone to discipline policy-makers and to allocate funds efficiently across borders might not be always optimal. In certain circumstances markets might tend to overreact and overshoot with respect to underlying economic fundamentals. In particular, the portfolio adjustment in a phase of transition characterised by several currencies acquiring international status might be quite disorderly. This might have negative effects on the world economy. It requires close monitoring and coordination by monetary authorities of the major economies.

A second issue, which is constantly discussed in the euro area but also in other countries, centres on what the relationship between an independent central bank and other policy-makers should be in order to ensure a consistent overall economic policy. This issue relates

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[2] See B. J. Eichengreen (2007): "The Breakup of the Euro Area", NBER Working Paper No. 13393. See also B. J. Eichengreen (2008): "Sui Generis EMU", NBER Working Paper No. 13740, on the unique features of EMU compared with past monetary unions.

[3] See ECB (2007): Review of the international role of the euro, June, available at www.ecb.europa.eu/press/pr/date/2007/html/pr070625.en.html.

to a number of areas and policies. In Europe the problem tends to become more complicated because some policies, such as fiscal and structural policies, are conducted at the national level while others, such as trade or antitrust policy, are conducted at the European Union level, not that of the euro area alone.

The euro area has in many respects a very strong policy framework, often underestimated. The relationship between monetary and budgetary policy is quite similar to that of most countries with an independent central bank, where there is no ex ante coordination between policies. There is an exchange of information, in particular on the state of the economy, but no trade-offs. This is the case in most industrial countries.

On exchange rate policy I believe that, as I have argued elsewhere, the euro area arrangements are good, as they involve both the finance ministries and the central bank.[4] In most other countries the central bank, which has the technical expertise over financial markets and is in charge of interest rate policy, is not involved or tends to get involved too late in the process, which may make things more complicated and risk undermining the credibility of any statement or action.

In the area of external representation, too, some clarity has been achieved as to who is responsible for representing the euro area, at least within the G7 and other groupings. Some confusion still remains in fora such as the G20, where it is the EU rather than the euro area that participates. In the IMF there is still no consolidation of the euro area members within one seat, something which to my mind will have to take place sooner or later.

On financial stability, the situation of the euro area is quite unusual, as the ECB has no direct responsibility for banking supervision. The situation is also varies within Eurosystem: in some countries the central bank has direct responsibility for supervising the domestic system, while in others this responsibility is given to another institution.

The recent turmoil has shown the importance of keeping central banks closely involved with issues related to the proper functioning of financial markets. Furthermore, the increasing integration of the EU financial market requires close cooperation between supervisors, from a more harmonised implementation of regulation to an effective exchange of information on markets and institutions, and the creation an efficient crisis resolution framework. Work on these issues is ongoing in Europe and will need to be further strengthened.

To conclude, as a last issue for discussion, we have in the euro area, as well as in other countries, a major challenge involving all policy-makers. It is to explain and help our citizens adapt to globalisation. Globalisation has produced many positive effects on our societies but is quite challenging for some social groups. In particular, the recent increases in food and energy prices are biting into the purchasing power of households, especially those at the lower end of the income distribution. These effects come on top of others that have developed over the years, which have squeezed the income of those employed in sectors with low value added.

I do not want to enter now into the debate of what is the best way forward. I will just mention that in Europe we have a further difficulty, i.e. that the euro has been introduced at the same time as globalisation has accelerated its effects. This has led some to confuse the effects of globalisation with those associated with the introduction of the euro. For instance, perceived inflation is in some countries higher than measured inflation, and some attribute this effect to the euro, even though over six years have passed since the introduction of the euro banknotes and coins.

[4] See L. Bini Smaghi (2007): “The euro as an international currency: implications for exchange rate policy”, remarks at the conference “50 years after the Treaty of Rome: strengthening the economic leg of EMU”, Rome, 2-3 July 2007.

Overall, euro area citizens have had to go through a series of adjustments in the last few years, which might have created a sense of confusion. This requires greater unity among policy-makers in the euro area, and less blaming of Europe and the euro – as has been the case in the past – in order to help our citizens adjust and recover confidence in the new environment.

The irony for somebody like me who travels frequently around the world is to notice that the benefits of the euro tend to be much more appreciated outside than within the euro area!

Thank you for your attention.