

Mr. Duisenberg looks at the international role of the euro and the ESCB's monetary policy

Statement by the President of the European Central Bank, Dr. Willem F. Duisenberg, at the Frankfurt European Banking Congress in Frankfurt am Main on 20/11/98.

I very much welcome the opportunity today to share some thoughts with you on the issue of the international role of the euro and the monetary policy strategy of the European System of Central Banks (ESCB). In order to remain within the tight time frame and leave room for discussion, I shall try to be as concise as possible, and I shall therefore focus on the three questions addressed to me directly.

1. Is a significant international role for the euro a desirable goal?

Some observers have asserted that one of the main motives behind Economic and Monetary Union in Europe is the creation of a major international role for the euro, and that fostering such a role would be an important objective for the European Central Bank (ECB). Both assertions are incorrect. The purpose of the introduction of the euro is to promote economic integration and economic welfare in the Member States, and the objective of the ESCB – and of the ECB as part of this system – is to maintain price stability within the euro area. The ESCB will take a neutral stance towards an international role of the euro. It will neither hinder nor deliberately encourage the development of this role, but will rather leave this to market forces.

The ESCB will, however, contribute indirectly to the international recognition of the euro by achieving its objective of maintaining price stability within the euro area. A successful monetary policy is a necessary condition, but not the only prerequisite for the international recognition and use of a currency. The reason is that the latter is a complex phenomenon. While there is no single international role for a currency, there are many uses for a currency in an international context. On the official side, they include the use of a currency as an anchor for exchange rate pegs, as a means of storing foreign exchange reserves, and as a vehicle for foreign exchange interventions. On the private side, they include the use as a quotation and vehicle currency for international trade, as a currency of denomination for financial assets, and as a substitute currency in circulation abroad. The significance of all these roles depends on the decisions of a large number of economic agents – including governments, central banks, institutional and private investors, corporations, and traders – which the central bank can only influence to a limited extent.

While it is difficult and not always meaningful to make predictions about the overall international role of the euro, it seems safe to assert that it will be significant in a number of areas.

First, there are what one might call the ‘static’ effects stemming from the changeover and the conversion of existing financial assets and liabilities into euro. That alone will already give the euro an internationally recognised role, since the euro area currencies, in general, and the Deutsche Mark, in particular, have played a significant role as anchor, reserve, investment and vehicle currencies in the past.

Second, and potentially even more important, there will be ‘dynamic’ effects stemming from new assets and liabilities acquired or issued in euro. Here, the creation of a large and liquid, integrated capital market will be the most important element in fostering such a development. For short-term instruments, there will be a broad and liquid European money market with a common overnight rate and very similar short-term interest rates for comparable instruments. At the longer end of the maturity spectrum, market integration will be jump-started by the re-

denomination of outstanding government debt in euro on 1 January 1999. The elimination of the currency fragmentation in the European bond markets will also lead to the development of uniform market standards and the creation of a large and liquid market for portfolio investors.

2. How will the euro's international role influence the ESCB's monetary policy?

Having an international currency has significant advantages for businesses and consumers. It may, however, sometimes complicate the conduct of monetary policy. In the ESCB's monetary policy strategy, developments in monetary aggregates play a prominent role, and these developments will be analysed very carefully. If a significant part of the money stock were to circulate outside the euro area and if its development were to deviate from that circulating inside the euro area, this could be a source of instability in money demand.

But this is only one of the challenges which the ESCB will be facing in analysing developments in monetary aggregates. Other challenges are related to changes in money demand as a result of the introduction of the euro itself. Together, these changes represent a structural break, and it is obviously difficult to predict how demand for money will evolve around such a break.

The ESCB has taken these difficulties into account in its monetary policy strategy in that, firstly, it will announce only a reference value for a monetary aggregate, and not a target value. This means that, although monetary developments will be used as the main indicator of potential inflationary or disinflationary pressures, the ESCB will not react in an almost mechanical way to correct deviations from the reference value in the short term. Secondly, the ESCB will not focus solely on the analysis of monetary aggregates, but will complement this analysis with a broadly based assessment of the outlook for future price developments.

On the one hand, the chosen strategy will, in my view, ensure as great a degree of continuity as possible in relation to the existing strategies of national central banks in the euro area. On the other hand, due consideration has simultaneously been given to the unique situation created by the transition to Monetary Union, in which a possibly growing international role of the euro is but one element.

3. What are the prospects for international policy co-ordination between central banks? Are target zones for the key currencies conceivable, or even desirable?

The ECB, acting on behalf of the ESCB, is already beginning to play a major role in international fora, such as those at the Bank for International Settlements (BIS), the OECD and in a G7 and G10 context, and I expect this role to grow considerably in significance once the ESCB is operational. In all fora, the ECB's role will be to contribute to the international policy discussions from the perspective that price stability in the euro area is its prime objective. At the same time, the ECB will seek to make the best contribution it can to stable international developments. In particular, the introduction of the euro will reduce the number of major currency blocs in the global financial system. In principle, this should simplify the exchange of views on financial issues at the global level. Each of the main partners – the United States, the euro area and Japan – will be in a position to speak for a comparatively large economic area and will be similarly vulnerable to possible consequences of instability. They may thus have a greater incentive to take on a share of the responsibility for helping to maintain a stable global environment.

On the question of exchange rates and target zones, I would like to state clearly that, in its monetary strategy, the ESCB does not have an exchange rate target. Nor do the United States and Japan. An exchange rate target for an area as large and relatively closed as that of the euro area could easily conflict with the maintenance of price stability and could, therefore, not be

sustainable. According to our monetary policy strategy, the exchange rate of the euro will thus be an outcome, rather than the objective, both of the economic, monetary and other policies pursued in the euro area, and of cyclical developments in the euro area and abroad. It will be monitored as one of the indicators of monetary policy and as a source of potential changes in the price level in the euro area. However, the exchange rate will play a far smaller role in the euro area than it has played in the Member States in the past.

In line with the ESCB's approach to the euro exchange rate, the Ministers of Finance, who are ultimately responsible for the exchange rate policy of the euro, have agreed to issue so-called exchange rate orientations only in exceptional circumstances, such as in the case of clear and persistent misalignments of the euro. This is apparently not the case at this juncture. Nor is there any indication that such misalignments will be unavoidable in the future. In particular, the fact that our strategy does not include any exchange rate target vis-à-vis the US dollar does not imply that the euro/dollar rate will be unstable or volatile, or that the ESCB is against reasonably stable exchange rates. The pursuit of stability-oriented monetary and budgetary policies on both sides of the Atlantic would put in place one of the major prerequisites for a reasonably stable euro/dollar exchange rate. At the current juncture, the policy framework in both regions seems to bode well for the adoption of such policies. Absolute stability is, of course, impossible to guarantee and would not even be desirable, if the United States and the euro area were to go through business cycles which are not fully synchronised.