

Mr Stark discusses the role and prospects of the euro in an international context

Speech by the Deputy Governor of the Deutsche Bundesbank, Dr. Jürgen Stark, to the European Institute in Washington on 26 April 1999.

I

Ladies and gentlemen,

More than three months have passed since the introduction of the euro. The transition from the multiplicity of national monetary policies to the single monetary policy of the Eurosystem was very successful on the whole. The fact that the transition passed off so smoothly was the result of a long and well-prepared process - entailing a great deal of effort - and of the excellent technical preparations made by the European institutions - in particular the ECB and the national central banks involved.

Undoubtedly, the start of monetary union constitutes a historic step in the process of European integration. But it will also have far-reaching external implications. It will constitute a major change in the international financial system.

II

In order to be able to join EMU, most EU member states had to make profound monetary and economic policy adjustments. Only those which met the four well-known convergence criteria of the Maastricht Treaty were allowed to become a “euro country”.

As regards “nominal” convergence - that is the trends in inflation rates, (nominal) exchange rates and long-term interest rates - considerable progress was made in some EU countries. Also, measures to consolidate public households were introduced, which resulted in most countries deficits being pushed below 3 % of GDP. Debt quotas were mainly lowered, even though this process began only in the second half of the nineties and some countries started from very high levels. Overall, 11 of the countries examined met the criteria for entry.

Although improvements were also made with regard to “real” convergence, marked discrepancies and shortfalls still exist in some countries. For example, growth rates in the euro area varied between 1 ½ % and 12 % last year. The lowest unemployment rate was just under 3 %, while the highest was almost 19 %.¹

Efforts must therefore be stepped up, particularly in the fields of fiscal, economic and structural policy, in order to create an economic environment in which the considerable growth potential of the euro area can be exploited. The aim must be to establish a sustainable basis for a stable euro and, ultimately, for a successful monetary union.

It is the stability of the euro and the success of EMU which will ultimately determine the international role of the new currency.

Ensuring the stability of the euro is, of course, first the responsibility of monetary policy, which has been assigned to the Eurosystem since January 1. Incidentally, monetary policy is

¹ European Commission, Economic Forecasts Spring 1999.

also making the most valuable contribution to growth and employment by ensuring price stability.

To enable the European System of Central Banks (ESCB) to fulfil its task, its independence was enshrined in the Maastricht Treaty (Article 107). Neither the ECB, nor a national central bank, nor any member of their decision-making bodies is allowed to take instructions from any government. Similarly, the governments of the member states shall not seek to exert any influence on monetary policy. In the last months, this second part of the article of independence was neglected by some parties.

The signatories of the Maastricht Treaty have, however, and rightly so, acknowledged that a “depoliticised” money can only be brought about, if all policy areas duly respect the independence of the Central Bank.

At the beginning of this month, the Governing Council of the ECB - fully independently and with total responsibility for price stability - lowered the interest rate for the main refinancing operations from 3.0 % to 2.5 %. This decision was in line with the two pillars of its strategy and was taken with a view to the future. It was generally welcomed. However, the ECB Governing Council made it clear that those responsible for other policy areas are now even more obliged to take the necessary steps.

III

The international role that the euro will play in the future will be determined particularly by the policies pursued in the euro countries. It will hinge crucially on the euro’s stability and the success of EMU and on the markets’ *confidence* in the new currency.

I should like to stress at this juncture that it was never intended to establish the euro as a “counterweight” to the dollar - although some commentators saw it like that.

The relationship of the European currencies to the US dollar had previously depended, in particular, on the size and openness of the respective economic area, the breadth and depth of the financial market, and the preferences of international investors. In the case of the D-Mark it was certainly the profound confidence of market participants in the stability of the German currency that established it as the second most important reserve and investment currency after the US dollar.

As far as the size and openness of the economic area and the growing integration of the financial market alone is concerned, the euro no doubt has the potential to become more important than all of the single currencies of the euro area put together. Expectations were therefore very high among politicians, and also among a number of academics, even before the start of monetary union. Those expectations have presumably even been reinforced by the advance confidence the euro had been given on the basis of the solid and stability-oriented institutional framework for monetary policy. It was assumed that

- there would be significant portfolio shifts in the euro area,
- that international investors would quickly add euro-denominated securities to their portfolios, and
- that central banks all over the world would diversify their foreign reserves to a greater extent in favour of the euro.

Instead, a certain disillusionment has emerged since the beginning of this year. However, very little time has elapsed since the introduction of the euro. Experience shows that the structure of international financial markets changes only very slowly. It is certainly too early to make a final assessment. We shall have to wait and see how things develop.

At present, the dollar is strong, while the euro has tended to decline in value since the start of monetary union. However, I do not see any reason to dramatise this. For example, the current exchange rate of the D-Mark against the US dollar is almost identical with its rate in the spring of last year.

When reasons for the weakening of the euro are sought, particularly three factors are mentioned:

Firstly, the so far robust state of economic activity in the United States, and *secondly* - in contrast to this - the slowdown of economic growth in continental Europe.

The resultant trends in interest rates have not failed to have an impact on the relationship between the euro and the dollar.

Thirdly, the euro has recently weakened further due to the situation in Kosovo, while the dollar established itself even more as a safe-haven.

There is yet another hypothesis about the recent performance of the euro:

Many investors are currently avoiding the euro area, because it obviously seems less attractive to them. Some analysts argue that this has something to do with the uncertainties about fiscal, economic and structural policy strategies particularly in the larger economies of the euro area. Their main question therefore is: does the euro lack political confidence?

IV

It is certainly not easy to establish a new currency in the current international environment. In this context, I would like to give particular emphasis to the fact that the European Central Bank is a new institution. In my opinion, this makes it all the more important to boost confidence in the euro and the Eurosystem. A stable euro and confidence in its stability are in Europe's proper interest.

What - apart from ESCB-independence - is required to guarantee a stable European currency and the lasting success of EMU?

The euro countries must not be content with the success hitherto achieved in terms of convergence. Monetary stability and the promotion of growth and employment must be seen as a lasting challenge. Greater efforts are required, in particular, in order to

- overcome certain signs of flagging in budgetary consolidation,
- and push ahead with the urgently needed structural reforms including the establishment of a tax framework that is conducive to growth.

Only if all the member states pursue stability-oriented and consistent financial, economic and structural policies will the euro be able to produce its positive effects on Europe's economies.

Incidentally, sound public finances and more flexible structures in the European economies are required not just because of the euro. They are also necessary in order to

- reduce government activities - which in some areas are exaggerated - and foster private initiative,
- prevent future generations from being burdened excessively
- and increase the impact of growth on lowering unemployment.

A few figures may illustrate this. On average, in the euro countries last year,

- the government spending ratio was almost 49 % of GDP,
- the debt level reached just over 73 % of GDP
- and the taxes and social security ratio came to almost 44 % of GDP.²

Only a successful monetary union and a stable euro will benefit our international partners, too. Europe's responsibility is not only limited to its own house, but relates to the global economy and the international financial system as well.

V

I am sure that in the medium term European monetary union will influence the international financial markets significantly. Monetary union has already created one of the three largest financial markets in the world and it will create a liquid financial market offering a considerably broader range of investment and financing instruments than is currently available in Europe's still fragmented financial market place.

The introduction of the euro will result in

- a fundamental change in European money, bond and equity markets
- higher transparency of financial markets
- intensified competition among financial institutions operating in Europe
- further promotion of technological changes and deregulation.

² European Commission, Economic Forecasts Spring 1999.

Instead of saying that the euro will compete with the US dollar it is – in my view – likely that the euro will, as the outcome of competition, increasingly complement the dollar as a reserve currency.

The euro will be used more extensively and the markets for financial assets denominated in euro will be greater in depth and breadth than compared with the multiple European currencies. This will provide incentives for countries to diversify their reserve holdings to be more in line with the currency composition of their trade and financial transactions.

VI

Finally, I would like to deal briefly with the question whether the euro might serve as a model for other regions. Two aspects seem important to me in this respect:

Firstly, the establishment of the euro reflects over 40 years of progress in strengthening economic, monetary and political ties in Europe. This process - which began as early as 1957 when the Treaty of Rome was signed - was difficult and not free from setbacks. I think that the high degree of convergence which had been reached in the euro countries before the single currency was introduced was important and necessary. But in the end each country has to decide for itself what the “best way” is. The decision to adopt a single currency is inevitably a political one.

Secondly, anyone considering any form of currency pegging and, even more, a monetary union must, above all, be fully aware of the consequences. Monetary union means relinquishing national sovereignty over internal and external monetary policy. Interest rate differentials and currency fluctuations, usually devices for readjusting economic competitiveness in the event of asymmetric shocks, have to be replaced by more market flexibility. Only with the needed structural flexibility may the potential fruit of a common and stable currency be reaped.

It is to be hoped for Europe’s sake that the euro will become a catalyst for structural reforms. I am sure that, if this is the case, the euro will find its proper place in the international monetary system.