Mr Noyer covers several topics on the euro: six months after its introduction

Speech delivered by Christian Noyer, Vice-President of the European Central Bank, at the Institute for International Monetary Affairs' (IIMA) seventh symposium on "The euro: its promise and challenge to the world economy" in Tokyo on 6 July 1999.

First, let me thank the organisers of this conference for inviting me to participate in this panel. Indeed, in my view, the title of this symposium, "The euro: its promise and challenge to the world economy", has been well chosen. The introduction of the euro, which was successfully launched just over six months ago, marks a significant milestone in the process of European integration and will bring considerable benefits to the nearly 300 million citizens of the euro area. The introduction of the euro will have a profound impact on the world economy, as well as the euro area itself, in years to come. However, the euro area also faces a number of challenges if the full potential of the single currency is to be realised.

The organisers have specifically asked me to cover several topics. Therefore, I should like to start my remarks by considering the current economic situation and the outlook for the euro area. I shall then explain the relationship between monetary and fiscal policy in the euro area and deal briefly with the issue of differing economic situations in Member States. Finally, I should also like to comment briefly on the question of structural reforms.

1. The current economic situation and outlook for the euro area

Real economy

According to a preliminary estimate released by EUROSTAT in mid-June, overall output growth in the euro area stabilised in the first quarter of this year. Real GDP in the first quarter was up 0.4% on the previous quarter, following a gradual slowdown from 0.7% to 0.3% during the course of 1998.

Even though caution should be exercised when interpreting these figures, since they combine data compiled partly in accordance with the old methodology and partly with the new (ESA 95), two broad conclusions may be drawn:

1. While previous data had suggested a rather sharp slowdown in the last quarter of 1998, the revised data imply a pattern of slowing real GDP growth which was spread more evenly over the course of 1998.

2. The weakening of output growth came to a halt during the first quarter of 1999. Data for industrial production for April 1999 confirm this picture.

Although there is not yet a clear sign of a recovery in the industrial sector, it appears that the level of industrial production stabilised over the first few months of 1999; a clear improvement compared with the pronounced decline of around 1% in the last quarter of 1998.

There have also been positive indications of economic activity in the euro area in recent business and consumer surveys. In particular, there was a further slight rise in business confidence, supported by an improvement in production expectations and a more favourable assessment of export order books, which may be seen as representing the more forward-looking components of the survey. At the same time, consumer confidence remains at an extremely high level; this is consistent with the fact that private consumption has remained robust, supported by real income growth and higher employment.

With regard to developments in the external environment of the euro area, there have been some positive signs. US growth is expected to remain strong in the near term, forecasts of growth for the United Kingdom (a significant trading partner for the euro area) have recently tended to be revised upwards and, of course, the Kosovo conflict has ended. There are also indications that prospects for several emerging economies have improved as financial turmoil has subsided and access to international capital markets has become easier. Overall, recent forecasts for the world economy suggest that the outlook has stabilised and the risk of a global recession has receded.

In all, there have been some indications of a turnaround in the industrial sector and of an improvement in the external environment. Overall, growth is expected to strengthen in the course of this year and next. Most observers now expect that real GDP growth in the euro area will be around 2% this year (compared with close to 3% in 1998) and 2.5% or more in 2000.

Prices

In response to these new data indicating a stabilisation of overall output growth in early 1999 and an economic recovery during the second part of 1999 into the year 2000, market participants appear to have shifted their expectations towards a faster pace of economic growth. Combined with recent monetary and credit developments, this suggests that downward risks to future price stability have receded further. On the other hand, all indicators we use in our monetary policy strategy do not signal upward inflationary pressures. This is true for money, with a development of M3 that remains close to the reference value, and also for the other indicators (combining financial market and real economy indicators including wage developments) that we use in our broadly-based assessment of the outlook for price developments.

The euro area yield curve has steepened somewhat more recently, as a result of a partial spillover of the sharp rise in long-term bond yields in the United States and the release of slightly higher-than-expected real GDP data for the euro area for the first quarter of 1999. However, long-term nominal bond yields in the euro area remain low by historical standards.

Annual consumer price increases in the euro area rose slightly from 0.8% in January 1999 to 1.0% in May. This small increase is mainly due to the impact of higher oil prices. Excluding seasonal food and energy, which are two of the more volatile components of the Harmonised Index of Consumer Prices (HICP), the rate of increase in consumer prices has continued to fall slightly in recent months, to stand at 0.9% in May. Recent forecasts of international organisations for inflation in the euro area over the next one to two years generally point to a range of around 1.0-1.2% this year and 1.4% in 2000.

Hence, all available evidence points to the conclusion that both in the short and medium term, price developments should be compatible with the Eurosystem’s definition of price stability, i.e. with increases in the area-wide HICP remaining below 2%.

Against this background, the Governing Council has decided during its recent meetings to keep interest rates on the monetary policy instruments unchanged.

Foreign exchange rate developments

Let me refer briefly to recent exchange rate developments. Since its launch in January 1999 the euro has fluctuated significantly against the currencies of our major trading partners but currently stands at a level that is broadly corresponding to the level of its constituent currencies that was observed in summer 1997.

This fluctuation has reflected a cyclical divergence between the euro area and the United States that is expected to diminish over the course of this year and thereafter. Given that the euro is a currency firmly based on internal price stability, it therefore has a clear potential for a stronger external value. Since the start of Stage Three of Economic and Monetary Union (EMU) the euro has become the second most important international currency in the world, and the policy of the Eurosystem will safeguard its internal purchasing power, which is a basis for a solid and stable currency over the medium term.

2. The Eurosystem's monetary policy and fiscal policies of Member States

I should like to emphasise that the Eurosystem's monetary policy strategy is geared towards the maintenance of price stability for the euro area as a whole. Before the establishment of Monetary Union, monetary policies in the countries that have now formed the euro area could, at least in principle, have reacted to country-specific developments. However, with the introduction of the single currency monetary policy decisions must be based on area-wide, rather than national, considerations. Clearly, to the extent that national developments have an impact on area-wide developments, the single monetary policy takes these factors into account, but the focus of monetary policy is on area-wide indicators.

The Treaty on European Union provides a fundamentally sound allocation of objectives and instruments between the single monetary policy and national fiscal policies in Europe. The Eurosystem is responsible for maintaining price stability. The Treaty also states that it shall support the general economic policies in the Community without prejudice to the objective of price stability. There is a widely shared view that maintaining price stability is the best contribution monetary policy can make to a high level of output and employment in the medium term.

As regards fiscal policy, the Stability and Growth Pact, which was agreed by EU Member States in order to avoid excessive deficits, provides countries in the euro area with a common code of fiscal conduct that requires discipline in the management of government finances. Member States are committed to respecting the medium-term budgetary objective of positions close to balance or in surplus. Safeguarding sound government finances is a means of strengthening the conditions for price stability and of achieving strong sustainable growth, which is conducive to employment creation. An open exchange of information among policy-makers is helpful for a proper assessment of the impact that fiscal policies have on developments in the euro area as a whole. This assessment will form one input - among others - into monetary policy decisions aimed at maintaining price stability over the medium term. One of the fora via which such an exchange of views is carried out is the regular Euro-11 meetings with the Ministers of Finance of the euro area in which the President of the ECB and I participate. Other exchanges will in the future take place in the macroeconomic dialogue established in the context of the European Employment Pact, which will bring together representatives of the Council of Ministers, the Commission, the ECB and the social partners in the form of a "macroeconomic dialogue". However, I should emphasise that these other exchanges remain limited to an exchange of information and do not interfere with the responsibility of individual policy areas.

3. The need for structural reforms to promote high and sustainable economic growth

I should like to emphasise how important it is that monetary policy is supported by structural measures to improve the functioning of labour, product and capital markets. This would also enable the economies of the euro area to operate at a higher degree of resource utilisation and thus make better use of the available productive capacity. In particular, it is widely recognised that the euro area faces a problem of high and persistent unemployment, which is largely structural in nature. There is therefore, a pressing need for measures targeted at making labour and product markets work more flexibly. Furthermore, flexible labour and product markets are also important to enable national economies to adapt to shocks, particularly those that do not affect the countries of the euro area equally. Monetary policy has to maintain price stability in the euro area as a whole, so national labour and product markets need to be flexible enough to adjust to such shocks.

Although some countries have adopted a wide range of measures, the progress made so far in pursuing structural reforms has been uneven and not yet satisfactory overall. However, there are some encouraging signs. Over the past few years, the European Community has stepped up its efforts in this field, aiming to co-ordinate and improve Member States' policies in the field of employment and labour market reform and to initiate reforms that improve the functioning of goods, services and capital markets. The experience of countries that have undertaken significant reform programmes shows that it takes time to implement structural reforms and even longer for the benefits of these reforms to materialise in full, but that these reforms bring about swift progress in employment creation and the reduction of unemployment.

Finally, let me stress that while there are challenges ahead, the independence of the Eurosystem, together with the clear mandate to maintain price stability in the euro area, provides a solid foundation for the long-term stability of the euro. The first six months of 1999 have seen the successful launch of the new currency. In the coming years the euro will make an important contribution to further economic and financial integration, helping to improve the growth potential of European economies.