Mr Noyer evaluates the role of the euro as a new stable currency for Europe

Speech delivered by Mr Christian Noyer, Vice-President of the European Central Bank, at the "Seminar on the euro" organised by the European Union Chamber of Commerce in Korea and the Federation of Korean Industries in Seoul and Pusan, Korea on 7 and 8 July 1999.

I should like to start by thanking you for your kind invitation to speak here on the occasion of the seminar on the euro. The first half year since the launch of the euro has been successful in both political and operational terms. With the introduction of the single currency, European integration has taken a large step forward as the new millennium approaches. Monetary Union is creating a zone of price stability among 11 participating European countries that fulfilled the convergence criteria set out in the Treaty on European Union, often referred to as the "Maastricht Treaty". Intense preparations by national authorities, a substantial process of disinflation and a high degree of nominal convergence among these countries have contributed to making the euro a reality.

Since the start of Monetary Union, the Governing Council of the ECB, as the central decision-making body, has been in charge of monetary policy for the euro area. The task of implementing monetary policy decisions taken centrally by the Governing Council lies with the Eurosystem, comprising the European Central Bank (ECB) and the national central banks (NCBs) of the Member States which have adopted the euro. The respective operational tasks are to a large extent carried out in a decentralised manner by the NCBs.

As my presence here in Korea shows, the euro also plays an important role outside the euro area. Just after its launch in January, the euro featured on all major financial markets around the globe. Currency trading is regularly carried out in euro, most European stocks are denominated in euro, and it has attracted new international bond issues that have frequently made use of the euro as the currency of denomination. As a means of payment the euro will significantly reduce transaction costs. For citizens living in the euro area and for international trading partners, transparency has been increased across euro area countries, as price comparisons between goods sold in different countries have been made easier. In some ways, the introduction of the euro may justify expectations that competition will be tighter in the euro area and that consumers are the likely beneficiaries of these developments.

For the euro to become a success story as the single currency for nearly 300 million people and as an international currency, the confidence of European citizens and of international investors in the stability of the new currency and in the Eurosystem are crucial. In its early days the Eurosystem has already made a start on building up credibility and gaining a sound reputation in financial markets for its monetary policy.

Monetary policy and other policy areas

Let me point out that the Eurosystem's stability-oriented 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 now form part of the euro area could, at least in principle, react to country-specific developments. However, within the new monetary policy framework of the Eurosystem this possibility is ruled out. Clearly, to the extent that national developments have an impact on area-wide developments, the single monetary policy takes these factors into account.

While a substantial process of disinflation and nominal convergence preceded the establishment of Monetary Union, cross-country differences, particularly in real developments, have recently attracted attention. Some observers have suggested that differences in national developments might turn out to be a complicating factor in the conduct of the single monetary policy. It is true that the cyclical positions of the participating countries have not completely converged in real terms. Such differences may exist for a number of reasons, reflecting country-specific institutional features, catching-up processes or economic structures that have evolved over time, all of which will still be present in the future. In our view, such differences in real economic developments across euro area countries do not pose a threat to the single monetary policy. After all, the same phenomenon can be observed between different parts of any given country.

Regarding price developments, some cross-country differences are difficult to avoid, for instance, those which relate to catching-up processes or to indirect tax changes. However, differences in inflation rates related to unsustainable wage developments or the lack of structural reforms in some countries are highly undesirable and urgently need to be tackled by appropriate policy adjustments at the national level. The Eurosystem can only focus on area-wide price stability. With the single currency in place and the successful implementation of structural reforms and sound fiscal policies, we would expect some of the remaining national differences to disappear over time.

The Maastricht Treaty 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 Maastricht Treaty also states that the Eurosystem shall support the general economic policies in the Community without prejudice to the objective of price stability. There is a widely held 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.

With regard to fiscal policy, in 1997 the Stability and Growth Pact was agreed among the governments of the EU. This Pact requires fiscal authorities to meet the medium-term budgetary objective of positions close to balance or in surplus. It thereby provides the right incentives for the conduct of sound and disciplined fiscal policies across all participating Member States. Safeguarding sound government finances is a means of strengthening the conditions for price stability and achieving strong sustainable growth, which is conducive to employment creation. In addition, structural reforms in labour and goods markets are the best way to address the underlying causes of the currently high level of unemployment in Europe, in particular the structural rigidities in the labour market. This clear division of responsibilities enhances the credibility of monetary and economic policies in Europe, increases transparency and facilitates accountability. At the same time, it requires national policies and labour and goods markets to be increasingly flexible in order to be able to respond effectively to economic shocks. Well-functioning labour and product markets are needed to enable adjustments to be made to wages and prices if local or global economic conditions change.

Against this background, an open exchange of information among policy-makers is most 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.

The Eurosystem's monetary policy strategy

Given the well known lags in the monetary policy transmission mechanism, it is important that monetary policy is conducted in a forward-looking manner with a clear focus on the medium term. Transitory factors that are not under the control of a central bank, such as sudden oil price shocks or changes in indirect taxes, may influence prices in the short term. To the extent that such factors represent one-off changes in the price level, these effects cancel out if a longer time horizon for the stabilisation of prices is chosen.

The Eurosystem, like any other central bank, influences future inflation by adjusting short-term interest rates. In the transmission of monetary impulses to the real sector, the behaviour of financial institutions, corporations and households is crucial. It is widely acknowledged that private expectations can facilitate the conduct of monetary policy, if the strategy and the objective of the central bank are well understood and credible. In order to stabilise public expectations of future price developments, monetary policy has to be transparent. Against this background the Eurosystem clarified in autumn last year how the mandate conferred on the ECB by the Treaty to maintain price stability is defined in quantitative terms.

Price stability has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. This has to be maintained over the medium term. The coverage of the HICP is quite close to that of the consumer price indices (CPIs) normally used. One advantage of its use is that the underlying statistical framework has undergone a process of intensive harmonisation within the EU.

As the wording “increase” in the Eurosystem’s definition of price stability makes clear, deflation - that is, a persistent fall in the price level - would not be consistent with price stability. Beyond that, it was not regarded as possible for us to announce where exactly we would draw the dividing line between price stability and deflation. This is partly for reasons that have been described as the measurement bias in consumer price indices. For the United States it was estimated that measured consumer prices tend to slightly overestimate actual inflation. A bias may also exist for the euro area HICP, although its exact magnitude is as yet unknown and needs to be explored further.

In order to maintain price stability, the Governing Council of the ECB has chosen a stability-oriented monetary policy strategy. The chosen strategy is forward-looking in nature and also ensures continuity with the former strategies of the NCBs. Moreover, it takes into account the fact that monetary policy decisions must be based on area-wide rather than national indicators.

The Eurosystem’s stability-oriented monetary policy strategy rests on two “pillars”, which are both important when the Governing Council discusses monetary, financial and economic developments at its bi-weekly meetings. The first pillar, which is a prominent role for money, takes into account the essentially monetary origins of inflation over the medium to long term. It recognises that empirical studies show a stable long-term relationship between money and prices in the euro area. Therefore, in the euro area monetary developments constitute an important guide for the conduct of monetary policy and it is essential to analyse and monitor the development of monetary aggregates closely.

The ECB has announced a quantitative reference value for broad monetary growth as measured by M3, the first reference value for M3 growth being set at an annual rate of 4½%. This reference value is consistent with the maintenance of price stability over the medium term, while allowing for sustainable output growth and assuming a trend decline in the velocity of circulation of M3. In setting the reference value for monetary growth, the Governing Council emphasised its medium-term orientation. Substantial or prolonged deviations of current monetary growth from the reference value will normally signal risks to price stability in the medium term. The choice of M3 was guided by its performance in terms of stability and leading indicator properties for future inflation. Let me mention that monetary policy in Korea also gives prominence to a broad monetary aggregate. Narrow aggregates were chosen as an intermediate target for monetary policy in Korea until the late 1970s, but then there was a gradual shift towards broader aggregates. More recently, in 1998, M3 was chosen.

The ECB does not intend to react to deviations of monetary growth from the reference value in a mechanistic way. In the first instance, such deviations are analysed thoroughly to infer any signals which they may give about the prospects for price developments. If a deviation points to a threat to price stability, monetary policy has to react in a manner appropriate to counter this threat.

Although monetary data contain information which is important for monetary policy decision-making, monetary developments alone clearly do not constitute a complete summary of all the economic information necessary for appropriate policy decisions to be taken. Thus the Governing Council emphasises that it is important, in parallel with the assessment of monetary growth, to look at a wide range of financial and other economic indicators, including economic forecasts. The second pillar of the Eurosystem's strategy therefore consists in a broadly based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole. This broadly based assessment takes into account, inter alia, the information provided by wage developments, exchange rates, fiscal indicators, real economic activity, and asset and commodity prices. Forecasts of economic activity and prices in the euro area can certainly also contribute to the success of an appropriately forward-looking monetary policy. Thus we take into account forecasts available from international organisations such as the International Monetary Fund (IMF) or the Organization for Economic Cooperation and Development (OECD) as well as internal forecasts.

Monetary policy decisions and the outlook for price stability

In December 1998 the Governing Council of the ECB announced that the level of interest on the main refinancing operation at the beginning of Monetary Union in January 1999 would be 3%. In the first quarter of 1999 the Governing Council kept this rate unchanged. In April, however, the Governing Council became concerned about downside risks to price stability, mainly stemming from the weakening of (domestic) economic activity. Consequently, the Governing Council decided to lower the interest rate on the ECB's main refinancing operations by 50 basis points to 2.50%. In parallel, the interest rate on the marginal lending facility was lowered to 3.50% and the interest rate on the deposit facility to 1.50%.

The Governing Council has kept the interest rates on its monetary policy instruments unchanged since April. It considered that at the current levels of ECB interest rates, price increases as measured by the HICP would continue to remain compatible with the Eurosystem's announced definition of price stability over the medium term. Let me explain the current assessment in the context of the stability-oriented monetary policy strategy.

M3 expansion has been close to the reference value of 4½% since the beginning of this year. The latest three-month moving average of M3 growth (covering the period from March to May 1999) increased somewhat to 5.2%, compared with 5.1% in the previous three-month period, mainly reflecting expanding overnight deposits. Given that this is close to the reference value, this is not regarded as constituting a signal of future inflationary pressures.

With regard to the broadly based assessment of the outlook for price developments and the risks to price stability, various indicators of future price developments and economic activity in the euro area signal a favourable outlook for price stability in the euro area. In recent months long-term rates have increased, mainly in response to the strong increase in long-term interest rates in the United States. Nevertheless, the still low level of long-term interest rates signals market expectations of consumer price inflation consistent with the definition of price stability.

The risks for the external economy appear to have become more balanced. In particular, the danger of contagion effects from the emerging market economies seems to be reduced. In a number of countries in South-East Asia the economic and financial conditions have improved. Let me also mention that exchange rate developments are taken into account in the Eurosystem's monetary policy strategy via their effect on the outlook for prices and the risks to price stability. Since the start of the year the external value of the euro has declined, bringing the effective exchange rate of the euro back to around the level observed for its constituent currencies in mid-1997. This development was strongly influenced by the cyclical divergence that strengthened the US dollar over the past few months. But we expect this divergence to diminish over the course of this year and next year.

Therefore with the strong commitment of the Eurosystem to internal price stability, there is clear potential for a stronger external value of the euro.

Recent price changes in the euro area have been affected by higher oil prices, which have fed through quickly to the energy component of the HICP. Nevertheless, inflation for the euro area as measured by the HICP has remained close to 1% since the fourth quarter of 1998 and hence has been consistent with price stability. In May 1999 annual consumer price increases were reported to be 1.0% for the euro area. Moreover, recent surveys and forecasts of inflation in the euro area covering the next one to two years indicate that consumer price increases are expected to remain below 2%.

Regarding economic activity in the euro area, little new information has become available in recent months. The assessment is currently somewhat complicated by the time-consuming introduction of a new methodology, namely the European System of Accounts (ESA 95). But according to the latest estimates (released by EUROSTAT mid-June), the weakening of output growth which was spread over 1998 came to a halt in the first quarter of 1999. Data on industrial production for April 1999 confirm this picture and the recent increase in business confidence, together with a maintained high level of consumer confidence are encouraging. All this tends to indicate that the European economy is picking up during the course of this year. The European Employment Pact, adopted at the summit of the European Council in Cologne this year, recognises the need to pursue comprehensive structural reforms and thereby sends the right signals. Starting to implement such reforms would also have an important confidence-building effect for the euro area and would support the conduct of a stability-oriented monetary policy.

With regard to public finances, it is crucial that structural reforms are accompanied by strict adherence to the requirements of the Stability and Growth Pact in order for the euro area to be better able to exploit its growth and employment potential.

The international role of the euro

Let me now briefly address the international role of the euro. Clearly, the introduction of the euro has had important implications for international capital markets. This has been the case not only because a number of the currencies which have now been replaced by the euro played an important international role in the past, but also because the euro has become the currency of an economic area which roughly equals the United States in terms of economic size and external trade, and which has the world's second largest capital markets.

The international role comprises a number of functions, which can be distinguished according to the official use of the euro and its use for private transactions. Concerning the former, the euro might be considered for official interventions in the foreign exchange market and similarly as a currency for official reserve holdings. Moreover, in the context of formal exchange rate arrangements, those countries that previously pegged their currency to one of the participating euro area currencies might, in future, peg their national currency to the euro. Private investors will use the euro for the international exchange of goods and services and for all kinds of portfolio investment. With regard to portfolio investment, the private use of the euro spans a broad spectrum from currency trading, bond and securities issues to investment in stocks.

One of the key elements encouraging international portfolio diversification in favour of the euro is the creation of a large, liquid and integrated capital market in Europe that began with the launch of the euro. For short-term instruments, we are now dealing with a broad and liquid European money market that ensures very similar short-term interest rates for comparable instruments and credit risks. The development of this market has been strengthened by the Eurosystem's operational framework of open market operations, which is mainly based on reverse transactions, and the implementation of the new TARGET real-time gross settlement payment system in participating countries. At the longer end of the maturity spectrum, market integration was jump-started by the re-denomination of outstanding government debt in euro and by the convergence of interest rates to narrower spreads following the elimination of exchange rate risk. The elimination of this risk will also foster the development of uniform market standards so that government bonds in the euro area will become relatively close substitutes, creating a large and liquid bond market. Obviously, this requires sound and sustainable budgetary policies that ensure that credit risk spreads remain small.

Among the important determinants of the international role of the euro two factors stand out, namely the size of the financial market and confidence in the currency. It is widely recognised that a large degree of openness of domestic financial markets normally also leads to a substantial use of the currency by foreign investors. At the same time country-specific risk features such as political risks can reduce the international use of the currency. Let me emphasise that the euro is backed by an environment of monetary stability with a medium-term orientation and which may be seen as providing sound conditions for the further enhancement of the international role of the euro.

Clearly, the disappearance of 11 national currencies and the introduction of the euro as a major international currency had an immediate impact on the turnover and focus of attention in the global foreign exchange markets. This has been reflected, for example, in relatively active and liquid euro/dollar trading in the foreign exchange market since the launch of the new currency.

The euro can also be expected to become an attractive currency for the investment of official reserves. Moreover, available information concerning the private use of the euro as a currency of denomination for debt securities indicates a significant increase in the share of international debt markets in the first quarter of 1999. This supports the view that in the medium term financial markets see the euro as a stable currency. Moreover, it is widely recognised that in the medium to long term exchange rates follow a path determined by fundamental factors such as price and economic developments. Thus, internal price stability should serve as an anchor for the development of the euro's external value in the medium term. Indeed, a stability-oriented monetary policy protecting the purchasing power of the euro is the basis of a solid and stable currency over the medium term.

As yet it is too early to predict how long it will take for the euro to be considered as a truly international currency similar to the US dollar. The Eurosystem neither promotes nor hinders the development of the euro as an international currency. We consider that the international role of the euro should develop through the interaction of market forces.

Concluding remarks

To conclude, the success enjoyed by the euro in its first half year can without doubt be attributed to a number of factors. Above all, the Member States were successful in their efforts to achieve a smooth changeover to the euro. The independence of the ECB and the clear mandate to maintain price stability are crucial to ensuring a high degree of credibility of the Eurosystem's monetary policy. Without the confidence of international financial markets and the permanent support of banks and financial institutions in the euro area and beyond, the single currency in Europe could not have become a reality. I am confident that we can expect also a continued support to making the euro a truly international currency.