Willem F Duisenberg: The introduction of the euro: a (critical) retrospect and a preview

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the meeting of the Dutch Society of Editors-in-Chief, The Hague, 15 March 2002.

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Ladies and Gentlemen,

It gives me great pleasure to talk to you today about the introduction of the euro. If we take the introduction of the euro banknotes and coins as a benchmark, then the process can be said to have been completed – and, if I might add, very smoothly and successfully so. However, if we take a broader perspective, then the introduction of the euro can be said to be an ongoing process. The euro area economy is large, in some respects complex and still very new on the map of major economic entities. These features imply that the policy challenges are manifold and will remain so for a long time to come. I would thus like to talk today not only about the cash changeover, but also about the policy challenges facing the euro area economy.

The policy area with which I am most closely involved is, of course, the monetary one, and the challenge for the ECB is to deliver what is required of it – namely price stability over the medium term. However, the existence of a single monetary policy and a single market implies that almost all fields of economic policy are affected by European economic and monetary integration – most importantly budgetary and structural policy. If I may be permitted to state the obvious, the challenges are to maintain sound fiscal policies, foster efficiency in public expenditure and tax systems and improve the functioning of labour and product markets in order to enhance the euro area's growth potential.

The unique framework of monetary, fiscal and structural policies in the euro area has fostered recent discussion about its economic governance, that is the "interplay" between monetary, fiscal and structural policies and the issue of whether and to what extent fiscal and structural policies, in particular, should become more centralised at the European level. This is an extensive list of issues (as requested by Mr. Broertjes), meaning that my focus must necessarily be a broad one. Let me now make a few remarks about the cash changeover, before proceeding to a brief discussion of the three key policy areas, namely monetary, fiscal and structural policy. I will finish my speech by briefly touching upon the issue of the economic governance of the euro area.

Cash changeover

With the end of the changeover period on 28 February 2002 the euro became the sole legal tender in all euro area countries with effect from 1 March 2002. Both in terms of acceptance by consumers and the achievement of logistical targets, the introduction of the euro banknotes and coins has surpassed all expectations. Here and there some minor mishaps have occurred, but this is quite normal for such a huge and complex undertaking. In any case, with the support of European citizens, who have accepted their new money both rapidly and enthusiastically, these minor difficulties have been overcome. European citizens have clearly chosen to be actors and not merely spectators in the euro changeover. According to the latest eurobarometer of the European Commission, over 80% of euro area citizens see the euro changeover as having been successful, and almost 70% declare themselves happy that the euro has become their new currency.

But what were the logistical factors which contributed to the success of the euro cash changeover?

First, measures were taken to ensure an early return of national banknotes and coins. One example which I would mention in this context are the campaigns which aimed at encouraging people to pay any surplus banknotes and coins into their bank accounts well before the end of 2001. Overall, the number of legacy currency banknotes in circulation fell by almost one-third during the course of 2001. By the end of the cash changeover period, some EUR 38 billion – or a little over 10% of the original amount of legacy currency banknotes – was still in circulation.

Second, the pre-distribution or "frontloading" of the "critical mass" of euro banknotes and coins made a crucial contribution to ensuring a smooth changeover in all euro area countries. A four-month lead time was required in order to ensure that sufficient euro banknotes and coins were available within banks and other target groups on 1 January 2002. This pre-distribution was a key factor in the successful attainment of one of the primary goals of the changeover process, namely to ensure that the bulk of cash transactions in euro could be effected within a fortnight of the new currency's introduction. All in all, more than 6 billion euro banknotes were distributed by the central banks of the euro area prior to "€-day". Nearly 38 billion euro coins were frontloaded in parallel. To put these figures into perspective, four-fifths of euro banknotes and almost all euro coins were frontloaded during this period.

Third, given that in normal circumstances around 70% of banknotes are put into circulation via automated teller machines (ATMs), a quick adaptation of these machines was crucial to a smooth changeover. It was necessary to convert a total of more than 200,000 ATMs, either "on-site" in bank branches or "off-site" – for example in shopping centres. Following thorough and highly efficient preparations by the banking sector, the adaptation process was extremely rapid, with virtually all ATMs converted by 4 January 2002.

A fourth factor which contributed to the smooth changeover was the particular commitment of the banking sector to putting the low-denomination banknotes of up to EUR 20 into circulation on a large scale at the beginning of 2002. This reduced considerably the need for retailers to hold large amounts of cash during the first few days of 2002. In addition, in countries where welfare payments are paid largely in cash, these were effected in low denominations. All this ensured that, at the beginning of the year, low-denomination banknotes accounted for over 80% of the total number of banknotes and for 40% of their value. This is clearly more than the usual share of low-denomination banknotes in banknote circulation.

Monetary policy

Let me now talk about the introduction of the euro from a broader perspective. I shall begin with monetary policy and the primary objective of the ECB, namely to maintain price stability in the euro area.

For the sake of this presentation, I would like to divide the first few years of the single monetary policy into three phases – rather artificially on the basis of whether inflationary pressures were seen as rising or falling. In the first of these, which began at the start of Stage Three of Economic and Monetary Union (EMU), inflationary pressures in the euro area were abating during a phase of economic slowdown at the global level which had started in 1998, following several episodes of financial turmoil around the world. The decline in economic growth was accompanied by a sharp reduction in commodity prices, which contributed to a significant fall in import prices. In this environment, the Governing Council decided, in April 1999, to reduce the key interest rates, to a level of 2.50% for the main refinancing rate. This was a precautionary move, aimed at reducing the risk that inflation could head towards and hover around very low levels.

In the course of 1999, the second phase in my breakdown, signs gradually emerged that a recovery in economic activity was taking place in the euro area. At the same time, oil prices were gradually but steadily increasing, and the exchange rate of the euro depreciated significantly. The resulting increase in import prices was having a substantial effect on consumer price inflation. In an environment of accelerating economic growth, to levels above potential, this could have been followed by what are known as second-round effects, with possible longer-lasting effects on inflation. In addition, the high growth of M3 – well above the reference value of 4½% – and the development of credit aggregates clearly indicated that risks to price stability were moving to the upside. The Governing Council therefore increased the key rates a first time in November 1999, reversing the precautionary move made in April, and a further six times in the period up to October 2000, by a total of 225 basis points.

Moving on to the third period, there were signs in late 2000 and in early 2001 that economic growth was gradually stabilising to levels in line with potential. This followed the effects of oil price increases on real disposable income in the euro area and accompanied a deterioration in the global economic climate, in particular the economic climate in the United States. At the same time, monetary growth was gradually declining to levels in line with the reference value and, in the course of the spring (when M3 growth could be corrected for some statistical upward distortions which were previously not known), even fell below it. However, in the spring of 2001 inflation was still above the ECB's definition of price stability, namely a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2%, to a certain extent owing to increases in unprocessed food prices resulting from the BSE crisis and the outbreak of foot-and-mouth disease in some countries. As these effects were expected to be temporary, in a situation in which it was anticipated that medium-term inflationary pressures would decline, the Governing Council acted in a forward-looking way and cut the key rates twice, in May and August 2001.

In the course of 2001 it gradually became more evident that the global economic downturn would be deeper and more protracted than initially expected, with repercussions on euro area economic developments. In addition, the terrorist attacks in the United States in September 2001 constituted a major shock to the world economy, the implications of which were entirely unpredictable at the time. In the first instance, these attacks threatened to disrupt the functioning of financial markets. Thus, immediately after the terrorist attacks, the ECB took measures to ensure the normal functioning of financial markets. The Governing Council also reacted to the events by holding an extraordinary teleconference meeting, at which it was decided to reduce the key ECB interest rates in concert with the Federal Reserve System of the United States. In the following period, as signs emerged that the slowdown in economic activity was significant, pointing in the direction of a further decline in inflationary pressures, the Governing Council again cut the key rates in November 2001, bringing the total reduction of the key rates in 2001 to 150 basis points. Since then, economic developments, which point to a gradual economic recovery in the euro area in the course of 2002, have been largely in line with the Governing Council's expectations, and we consider the current level of the key ECB interest rates appropriate to maintaining price stability over the medium term.

To briefly conclude on monetary policy, the ECB has, in my view, proved itself capable of adapting to and operating in a difficult economic environment. While inflation has been above the definition of price stability for some time, medium-term inflationary expectations, as implied in bond yields or in forecasts and surveys, have consistently been below 2%. This is a sign that the credibility of the ECB is firmly established and that the public is confident that price stability will prevail.

Fiscal policy

The economic environment with which we at the ECB were confronted was also the day-to-day reality of the fiscal policy-makers in the individual euro area countries. In 2001, mainly as a result of the economic slowdown, the average budgetary balance in the euro area deteriorated for the first time since 1993. Automatic stabilisers played a significant role in budgetary outcomes in 2001. Major tax cuts also contributed to the deterioration, as they were often implemented without adequate offsetting expenditure restraints. As a result, a large majority of countries failed to meet the budgetary balances targeted in the stability programmes for 2001. By the same token, most countries rightly refrained from introducing a discretionary fiscal relaxation in response to the economic slowdown. Moreover, countries with remaining fiscal imbalances reaffirmed their commitment to attaining safe budgetary positions by 2003 or 2004.

Developments in 2001 and the projected outcomes for 2002 confirm the vulnerability of public finances – especially in the countries with remaining imbalances. The European Commission recommended issuing an early warning to Germany and Portugal. The ECOFIN Council considered the subsequent reaffirmation and even strengthening of the fiscal commitments made by these two countries a sufficient response to the concerns. Vigilance is now needed to ensure both strict adherence to medium-term plans and rigorous implementation of the procedures of the Stability and Growth Pact.

To briefly conclude on fiscal policies, recent experience shows how rapidly a budgetary position can deteriorate in adverse cyclical circumstances. This is of concern when the starting position is not fully sound. In my view, then, the main lesson to be drawn from recent experience is that, under normal circumstances, countries need to be in budgetary positions close to balance or in surplus.

And let us not forget that the medium-term challenges of coping with an ageing society also call for fiscal consolidation. Moreover, the 2000 Lisbon European Council put structural reform of public finances high on the agenda, with an eye to strengthening the European Union's growth potential.

Structural policies

At the summit in Lisbon, the European Council also emphasised the need for product and labour market reforms as a key condition for the EU to become the most competitive and dynamic economy in the world. Structural reforms aimed at increasing the flexibility of euro area product and labour markets would, it was underlined, have substantial economic benefits and lower the adjustment costs associated with economic shocks. That we still need further structural reforms is, I think, beyond doubt. To take an example from the labour market: the strong employment growth witnessed in recent years suggests that labour market reforms have been progressing in the right direction, and, in particular, it suggests that the process of wage moderation in the euro area during this period has been beneficial. At the same time, however, the need for further reform is evident from the still high and persistent levels of unemployment and from low labour market participation in several euro area countries. For example, despite continued high unemployment, firms continue to report difficulties in recruiting suitably qualified workers, suggesting that improvements are needed in matching labour supply and demand.

Economic governance

Finally, let me turn briefly to the issue of economic governance. With the start of Monetary Union, the Maastricht Treaty created a unique institutional structure. While there is a supranational European monetary order, most other policy areas are predominantly a national matter. This unity in diversity reflects Europe, with its wealth of different histories, cultures, political systems and constitutions. In principle, this structure has functioned relatively well and there is no need for a major overhaul. In some areas there is a clear case for permanently adopting a differentiated approach, for example in the case of labour market policies. Harmonisation in this field would hamper the very flexibility of prices and wages that each country, or even region or sector of the national economy should pursue for Monetary Union to be successful. In other areas, such as tax policies, there may be a gradual development towards more co-ordination between Member States.

Diversity and differentiation should not in themselves be viewed as reflecting a lack of economic governance. On the contrary, the experience of the recent past bears out that this form of governance works well in practice. For instance, decentralised wage setting has led to broadly appropriate wage development in the recent past and contributed to employment growth. Monetary policy has kept inflation under control and reacted swiftly under circumstances which have sometimes been difficult. On the whole, fiscal policies have also reacted in a way which is compatible with both the economic environment and their medium-term objectives. All in all, there is clear evidence that policy-makers have acted appropriately in all three areas.

Conclusion

Let me conclude. The cash changeover has been a resounding success. From a logistical point of view this operation proceeded very smoothly, thanks in large part to the comprehensive preparatory work undertaken by all involved. The people of the euro area countries have adapted to the new currency much more quickly than the ECB and the national central banks anticipated. In addition, notwithstanding the adverse price shocks to which the euro area has recently been subject, the prospects are good that annual inflation rates will return to below 2% in the coming months. Overall the ECB's monetary policy has been successful in maintaining stable long-term inflation expectations in a difficult environment. It is important to maintain the disciplinary effect of the Stability and Growth Pact; recent experience has shown how quickly a budgetary position can deteriorate, thus highlighting the importance of reaching and maintaining medium-term budgetary positions close to balance or in surplus. Structural policy is an area in which further action is also urgently needed. Finally, the economic policy framework of the euro area has been functioning satisfactorily, even in the largely unprecedented circumstances of 2001.

Thank you very much for your attention. I am now open to questions.