Willem F Duisenberg: Some remarks on the euro in a US context

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at a breakfast meeting of the Council on Foreign Relations, New York, 19 April 2002.

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Introduction

It is an honour for me that Paul Volcker has introduced my presentation this morning. Under his chairmanship and that of Alan Greenspan, the Federal Reserve has made an invaluable contribution to the well-being of the American people, and to the world economy. Paul Volcker managed to stop the inflation spiral, which started in the early 1970s, and turned it into a sustained disinflation process. The low inflation record combined with high real growth in the 1990s here in the United States also owe a lot to the courageous and determined policy that Paul Volcker carried out in the 1980s, which gave clear priority to monetary stability.

It is also an honour for me to address such a distinguished audience in the United States. In particular last year, the attention of the European Central Bank (ECB) and the national central banks of the European countries that have adopted the euro – jointly referred to as the Eurosystem – was focused on communicating to the 300 million citizens of the euro area the ins and outs of the introduction of the euro, in particular the euro banknotes and coins. At the same time, the ECB realises that it is also important to address audiences outside the euro area and the European Union. Although we refer to the euro as 'our currency', the impact of the euro goes beyond the boundaries of the euro area. Indeed, the euro may be referred to as one of the key currencies in the world, with the Eurosystem being the central bank responsible for issuing it.

In particular, people on this side of the Atlantic may be interested to learn more about the euro. Indeed, knowledge of what is happening in Europe in this respect still seems to be rather limited. This is partly because, in the 1990s, US commentators were somewhat critical of European policy makers seeking to establish a monetary union. Many of these commentators thought the Europeans were 'building castles in the air'. However, as 1 January 1999 approached, the date when the exchange rates of 11 European countries were irrevocably fixed and the euro was introduced, it became clear that, indeed, something special was happening in Europe.

In my speech today, I would like to elaborate on some key aspects of the euro area. I would like to put them in a US context, and recall the scepticism expressed about the euro by some US commentators. To be more precise, my remarks this morning will focus on the following questions:

- Is it possible to have a single currency without having a nation-state?
- Are the economies of Europe sufficiently homogeneous to handle a single currency?
- Last but not least, how does the euro area monetary policy function?

A single currency without a nation-state

Many US commentators thought that the euro would not fly, as the European Union does not constitute a nation-state. They argue that it is difficult to conceive how sovereign states, such as the members of the European Union, can give up their monetary independence. To back up their case, these commentators sometimes refer to the United States. The US dollar was introduced in 1792 as the currency of the young nation-state that was established in 1789. Indeed, the currency was regarded as an expression of the unity of the young nation and its independence from the British crown.

However, in economic and even cultural terms, this young nation was a very heterogeneous collection of former colonies and in many respects, apart from the common language, perhaps much more diverse than the current euro area.

It is also interesting to note that although the US dollar was introduced almost at the same time as the United States was established, the US could hardly have been called a fully-fledged monetary union in those days, at least not according to our current definitions. Besides some ill-fated and short-lived attempts in the late 18th and early 19th century, the United States did not have a central bank, responsible for issuing the currency, until 1913, when the Federal Reserve System was set up. Moreover, effective banking laws were also lacking, at least until 1863, when the National Banking Act became law. Indeed, throughout much of the 19th century, exchange rates between US states underwent de facto fluctuation, due to the excessive use of paper money, the quality of which differed from one state to another, and the absence of widely accepted currency in the form of gold and silver. At the same time, the process of political union in the United States remained incomplete, as the Civil War in the 1860s manifestly demonstrated. One can even argue that the current constitutional and political set-up of the United States and division of responsibilities between the federal and state governments goes back to the 1930s, the aftermath of the Great Depression. The point that I would like to make is that – like in Europe – monetary and political integration were lengthy processes that went hand in hand, processes that were much more complicated than some of these commentators would have us believe.

Moreover, in order to understand why Europe has successfully introduced a single currency without being a nation-state, it is important to grasp the history and essence of the European integration process. Having been the initiator and to a large extent the theatre of two world wars, European countries realised they could only avoid the horrors of another armed conflict by coming closer together. The strategy was, and still is, to link the countries of Europe by gradually integrating their markets and economic policies. By doing so, political integration will follow. In 1968 a customs union was established among the countries of the then European Economic Community, followed by the establishment of a European single market in 1993. In order to make a single market, i.e. ensure the free movement of goods, services, capital and labour, it was felt necessary to introduce a single currency. And as you know, this most recent step in the European integration process occurred in 1999. Its introduction was a logical step in an integration process that started after the Second World War and which will ultimately lead to ever closer ties between the countries of Europe.

The euro area: a fairly homogeneous economic entity

US commentators were also sceptical about the homogeneity of the European economies. A single currency would only be beneficial if the potential members of the monetary union were fairly homogeneous. If not, countries would no longer be able to adequately respond to diverse economic developments, as they could not let their exchange rates fluctuate. These commentators also argued that the European countries had no other adjustment mechanisms, such as a high labour mobility or fiscal stabilisation, which might serve as a substitute for exchange rate flexibility.

However, in my view, there are very good reasons for having a single currency in those Member States of the European Union which have sufficiently converged. This is supported by the experience gained in the three and a half years since the introduction of the euro.

First, economic research and empirical evidence has shown that countries in Europe are not as heterogeneous as the critics of the euro project often claim. Indeed, compared with the differences between the economic structures and business cycles of US regions, the European countries score relatively well. The research has also shown that a given region in the US will recover more quickly from an economic shock than a region or a country in Europe. However, these results are based on data collected before the introduction of the euro. The adoption of a single currency in Europe will most likely have made economic structures in Europe more homogeneous. In addition, since the early 1990s, Europe has undertaken structural reforms that have contributed to the flexibility of product and labour markets.

Second, although labour is much less mobile between European countries than between US states or regions, the European Member States nevertheless have some fairly powerful (fiscal) stabilisation mechanisms at their disposal, in case countries are affected by shocks. In contrast to the United States, the 'federal budget' of the European Union is very small and fiscal policy is a national prerogative. This also implies that member countries have the capacity to tackle shocks by themselves and do not require the assistance of the 'federal budget'. How does this work? The Member States of the European Union have signed the Stability and Growth Pact. This Pact requires, among other things, that national governments should pursue – over the medium-term – a balanced budget or a surplus. This allows countries to let automatic stabilisers function if they are affected by economic shocks. The budget deficit of a Member State is, under normal cyclical circumstances, not allowed to exceed 3% of GDP. However, research has shown that if countries do indeed stick to the Stability and Growth Pact, they should be able to absorb economic shocks and fluctuations in the business cycle by letting automatic stabilisers function, without breaching the 3% limit.

Third, in many areas there are obvious benefits from maintaining a decentralised political structure. As we know, monopolies – both those exercised by companies and centralist governments – are harmful to growth and welfare. Competition between jurisdictions can often be as healthy as in the market economy. In that respect, the EU is not far away from the set-up in the US, if one disregards some key areas like foreign and defence policy.

Key aspects of the ECB's monetary policy

I have attempted to explain why some of the criticism made by US commentators regarding the introduction of the euro is not justified. Indeed, the experience with the single currency so far has proved these critics to be wrong. Finally, as I am first and foremost a central banker, let me now turn to the monetary policy pursued in the euro area.

With the introduction of the euro on 1 January 1999, responsibility for monetary policy-making was, by definition, transferred from national to European level. This shift necessitated the creation of the ECB. As already mentioned, the ECB and the national central banks of the euro area countries make up the Eurosystem. The Eurosystem, which has the traditional functions of a central bank, may be referred to as the central banking system of the euro area, which is virtually identical to the Federal Reserve System in the United States.

Decisions on monetary policy are taken by the ECB's Governing Council, which consists of a six-member Executive Board and the Governors of the national central banks of the 12 countries currently in the euro area. The members of the Governing Council consider the interests of the euro area as a whole; they do not represent their respective countries. The authority and functioning of the Governing Council over, and in relation to, monetary policy decisions is, again, very similar to that of the Federal Open Market Committee in the US context.

Let me now list some of the key aspects of the ECB's monetary policy framework.

First and foremost, the ECB's primary objective is to *maintain price stability*. This mandate stems from the Treaty on European Union, which formed the blueprint for Economic and Monetary Union and was ratified by all the national parliaments of the European Union. The ECB is convinced that by focusing on price stability central banks contribute significantly to a society's well-being. Apart from credibly preserving price stability, monetary policy can do nothing to enhance the potential growth rate of the economy. In fact, the policy task of improving long-term growth prospects is entirely in the hands of governments. They need to carry out structural and fiscal reforms, which should aim to reduce rigidities and enhance the flexibility of labour and goods markets, via restraining tax wedges and by maintaining proper incentives regarding the demand and supply of labour, in a context of sound public finances.

In order to make the ECB's objective operational, a quantitative definition has been set for price stability, as the Treaty on European Union has mandated the ECB to maintain price stability. To anchor expectations and to offer a yardstick against which the ECB can be held accountable, the Governing Council of the ECB provided a numerical definition of price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". The Governing Council also emphasised that price stability has to be maintained over the medium term. The focus on the medium term acknowledges that monetary policy cannot steer price developments in the short term. At the same time, it reflects the notion that measured policy reactions to threats to price stability can prevent unnecessary volatility being introduced into the economy.

The ECB's quantitative definition of price stability has established a range of inflation outcomes deemed compatible with price stability. The range definition that we have adopted reflects the degree of uncertainty attached to the meaning and measurement of the concept of price stability. It allows uncertainty about the measurement bias in the HICP to be accommodated within the range, while ensuring that "true" price stability (zero inflation) is included. Moreover, the definition provides a "buffer" in the face of economic shocks and avoids the impression that monetary policy is equipped to fine-tune price developments with a high degree of precision.

Regarding the definition of price stability, I wish to emphasise two further aspects. First, it is defined with reference to the euro area as a whole. The ECB has made it very clear that monetary policy cannot, and should not try to, address regional or local economic problems. Secondly, the Governing Council aims to avoid both inflation and deflation. We are well aware of the potential problems associated with the hitting of the zero lower bound on nominal interest rates and the attendant potential loss of effectiveness in the conduct of monetary policy under conditions of persistent price deflation. This is an important reason why there is a safety margin, in the form of small positive inflation rates below 2%, in our definition.

In order to form an appropriate assessment of the success or failure of the ECB's monetary policy, the medium-term orientation of the ECB's policy should be borne in mind. Monetary policy needs to be evaluated over a sufficiently extended period. The ECB's policy can be considered successful if price stability, according to our definition, has prevailed for most of the time and if variability of inflation has remained low.

From the start, the definition set by the Governing Council has served very well the purpose of anchoring medium-term inflation expectations. This is evident from inflation expectations derived from market surveys or from the analysis of yields on long-term bonds. This stability of inflation expectations is remarkable given that we had to face substantial shocks to the price level in the euro area – mainly stemming from energy and food prices – over the past three years. The definition of price stability has thus reduced inflation uncertainty, thereby lowering the risk premia included in long-term interest rates.

I would finally like to address one other key aspect of the framework according to which the ECB tries to pursue its objective. The recognition that monetary policy has to cope with an ever changing and imperfectly known world has been an essential consideration in the design of the ECB's monetary policy strategy. Besides defining price stability, the Governing Council chose to equip itself with a broad but robust framework for analysing economic developments and shocks, which we call the two pillars of our of monetary policy strategy.

In recognition of the fundamentally monetary origins of inflation, our strategy assigns a prominent role to money in the formulation of monetary policy. This so-called first pillar of the ECB's strategy implies the use of approaches and models in which monetary aggregates play an important role in analysing risks to price stability. In parallel, the second pillar ensures that other forms of analysis and models, such as the investigation of the interplay between supply and demand as well as cost-push dynamics, are incorporated into the analysis of price developments. Also, the Eurosystem staff projections regarding the economic outlook of the euro economy are analysed in the context of this pillar. Together, the two pillars ensure a comprehensive assessment of the economic situation and allow a focus on the nature of the shocks hitting the euro area.

Conclusion

Ladies and Gentlemen, I am coming to the end of my remarks here today. The introduction of the euro has been an outstanding achievement. In particular, the introduction of the euro banknotes and coins went much more smoothly than initially expected. The success of the whole undertaking shows that many of the critics who opposed the euro in the 1990s were indeed wrong. Moreover, the success of the euro can be attributed to the sound economic and monetary framework laid down in the Treaty on European Union, which includes the tasks and functions of the ECB.

I hope you will agree that the differences between the practices of major central banks oriented towards price stability are in fact relatively limited. All these central banks share a number of key elements that guide the conduct of monetary policy. However, the experience of central banks worldwide also shows that there is no single, unique way to successfully conduct monetary policy. Perhaps it is no accident that the monetary authorities of the world's two largest currency areas – the Federal Reserve System and the Eurosystem – have eschewed excessively simplified and rigid frameworks to conduct policy. They have consciously chosen to enlarge, rather than narrow, on a priori grounds, the set of indicators which they routinely monitor.

I thank you for your attention. I am now happy to answer your questions – that is, to the same extent as most central bankers would answer them.