Mr Noyer discusses "the euro from A to Z"

Speech delivered by Mr Christian Noyer, Vice-President of the European Central Bank, at the European Union Centre, Sam Nunn School of International Affairs, Atlanta on 14 January 2000.

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It gives me great pleasure to speak to such a (young) audience about what is, after all, the world's youngest and newest currency. As indicated by the title of my speech, I do not intend to enter into complex economic and political considerations concerning the pros and cons of the introduction of the euro under the specific economic and political conditions prevailing in Europe. Rather, I should like to provide you with a concise overview, from A to Z, of the main elements of the new institutional and operational framework under which monetary policy is being conducted in Europe following the introduction of the euro. Nonetheless, I do hope to be able to enhance your understanding of the euro, both in the broader context of European integration and in terms of the practical functioning and implications of Economic and Monetary Union (EMU) in Europe.

In this context, you will see that there are some similarities between the institutional framework and conduct of monetary policy in the United States and in Europe. At the same time, there are also substantial differences, particularly with regard to the political and economic framework in which monetary policy has to operate on your side and our side of the Atlantic.

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The successful introduction of the euro represents one of the greatest achievements in modern European economic history and, in order to understand how it came to be that 11 European countries decided to relinquish their monetary sovereignty and adopt a common currency, one must first look back, at least briefly, over 50 years of European integration.

The first concrete step towards achieving this goal was taken when the continent lay in ruin following the Second World War and six countries signed the Treaty of Paris in 1951 establishing the European Coal and Steel Community (ECSC). This Treaty not only led to the removal of barriers to trade and the creation of a "common market" in coal and steel products, but also transferred powers previously exercised by the Member States in the coal and steel sectors to a newly established and independent High Authority.

This showed how economic integration could serve not only as a means of fostering increased trade and improving economic welfare, but also how it could act as a driving force behind greater political integration by increasing the interdependencies between the participating Member States. When, six years later, the same six countries signed the Treaty of Rome establishing the European Economic Community (EEC), the same approach was extended to virtually all sectors of the economy with the explicit aim of creating an ever closer union among the peoples of Europe and a common market within which goods, capital and labour would circulate freely.

Since then, the process of European integration has continued to develop. Throughout this process national policymakers, economic actors and the general public have each had to undergo a learning process whereby the previous, narrowly defined, national perspectives have been replaced by an increasingly European vision. This was and is not always easy.

Today, the European Union stands for a highly integrated single market with about 380 million people, which combines the economies of 15 European countries and accounts, like the United States, for around 20% of world GDP. Moreover, it stands for a Monetary Union with a common currency, the euro, which, at present, has been introduced by 11 countries. Finally, the European Union, even though it lacks international personality, is characterised by a substantial and growing degree of political cooperation and coordination. This applies to justice and home affairs as well as to foreign and security policies.

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The dynamics of the integration process and, with it, the increasingly European outlook of both politicians and citizens was essential for creating an environment in which Europe's leaders could take the bold decision to adopt a single European currency. But there were also a number of more specific factors that facilitated this decision, some of which I should briefly mention.

The first of these was the signing of the Single European Act, in 1986, which committed the then European Community of 12 to adopt the measures necessary to complete the "single market project" by the end of 1992. This not only created a dynamic towards further integration, but also resulted in a growing realisation that a truly single European market could not be created while currency fluctuations and the exchange rate risk continued to create de facto barriers to trade. Then, in 1989, the collapse of the communist regimes in Eastern Europe and the fall of the Berlin Wall provided Europe's leaders with an opportunity to shape the Europe of the future in ways that had been unimaginable before.

If the completion of the single market project and the fall of the Berlin Wall created the necessary dynamics, the changing economic environment and, with it, the growing economic policy consensus removed, at the same time, many of the obstacles that had previously stood in the way of European Monetary Union. Increased international capital flows and the removal of restrictions on cross-border capital movements made it virtually impossible for individual Member States to pursue truly independent monetary policies without this resulting in destabilising capital flows and, ultimately, a reversal of policy. Moreover, it had, in any case, come to be universally accepted that monetary policy could not be used successfully to stimulate economic growth, but should instead focus on maintaining stable prices, thereby also creating an appropriate climate for sustainable growth. Since it was now considered neither possible nor desirable for individual countries to pursue significantly diverging monetary policies, both the real and the perceived losses that might result from relinquishing monetary policy sovereignty and adopting a single currency had been significantly reduced.

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Returning to the present day, a little more than eight years after Europe's leaders signed the Treaty of Maastricht and agreed on the necessary framework and timetable, we now have a functioning EMU with a single European currency. Nonetheless, I would not be surprised if, to some external observers, EMU might at first glance appear rather unusual and perhaps even somewhat confusing. This is no doubt a consequence of some of the specific features of EMU that I should take some time to explain. This also holds true of the European Union, which still does not fully correspond to the model of a union you may have in mind, namely the United States.

Starting from basics, I should point out that some of these specific features relate to the fact that while the European Union is comprised of 15 Member States, only 11 of these have so far adopted the euro. We cannot therefore talk about the single monetary policy of the European Union, but rather, for this purpose, we must instead refer to the euro area, the euro zone or, as some people have chosen to call it, Euroland.

A similar problem arises when we wish to refer to the authority responsible for the conduct of the euro area monetary policy. The Treaty establishing the European Community stipulates that this policy is to be conducted by an independent European System of Central Banks (ESCB), which comprises the European Central Bank (ECB) and the national central banks of the 15 EU Member States. However, since four of the national central banks which form part of the ESCB continue to conduct their own autonomous monetary policies, one cannot accurately refer to the ESCB as the authority responsible for conducting monetary policy in the euro area. We must instead use the term "Eurosystem", which comprises the ECB and the 11 national central banks of those countries which have adopted the euro, and which has been adopted as a "user friendly" expression to denote the form in which the ESCB performs its tasks and responsibilities.

The Eurosystem is set up, like the Federal Reserve System, in a distinctively decentralised manner. At the same time, however, the Eurosystem disposes of marked centralised structures, since the definition and implementation of the single monetary policy are carried out under the exclusive responsibility of the decision-making bodies of the ECB. These are, first of all, the Governing Council, which defines the single monetary policy for the euro area and takes all other decisions of fundamental importance to the Eurosystem. The Members of the Governing Council are the Governors of the 11 national central banks and the six members of the Executive Board of the ECB. Basically, all decisions are taken by simple majority, whereby each member has one vote. The other important decision-making body is the Executive Board of the ECB, which is basically responsible for the implementation of monetary policy in accordance with the decisions taken by the Governing Council.

Against the background of this centralised decision-making structure, the role of the 11 national central banks consists mainly of the practical implementation of monetary policy and other tasks of the Eurosystem, such as the issuance of banknotes, the collection of monetary statistics or the operation of the Eurosystem's payment systems. The fact that these tasks have to be carried out on the basis of agreed rules and specific instructions given by the decision-making bodies of the ECB, however, by no means lessens the importance of the national central banks in the overall set-up of the Eurosystem.

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Another particular characteristic of EMU is that, while Monetary Union has led to the introduction of a single monetary policy, Economic Union has not resulted in the development of other common macroeconomic policies, which instead remain in the hands of the national governments of the Union's Member States. With a centralised monetary policy and decentralised fiscal and structural policies, the economic and monetary pillars of EMU can appear to be somewhat uneven at first glance. But we should not be fooled by appearances. In fact, the structure of EMU's economic pillar reflects the need to strike an appropriate balance between providing flexibility and diversity, while - at the same time - ensuring that all of the economic policies of the euro area contribute to the success of EMU.

Two factors have to be considered in this regard. First of all, in a Monetary Union which covers an area stretching from Lapland in the north of Finland to Andalusia in the south of Spain, we cannot expect complete homogeneity of the economic cycle or of economic conditions in a more general sense. Therefore, it makes sense for the euro area Member States to maintain control over the remaining tools of economic policy so as to be able, if necessary, to respond to developments which are particular to their own economies.

On the other hand, when formulating their economic policies, euro area Member States must give sufficient consideration to the impact that these policies will have on the rest of the euro area economy. This is particularly important in EMU since euro area countries are no longer exposed to the discipline of financial markets to the same extent as used to be the case when they conducted their own autonomous monetary policies. Prior to the introduction of the euro, unsustainable economic policies were penalised by the markets in the form of higher interest rates, substantial risk premia and exchange rate pressure. In EMU, however, where financial markets take an increasingly euro area-wide focus and where the exchange rate risk associated with national currencies no longer exists, the effects of inappropriate policy choices in any one country tend to be largely spread across the entire euro area. Only relatively small risk premia remain.

For these reasons, the euro area Member States are obliged to treat their economic policies as a matter of common concern and, to this end, a number of instruments and procedures have been developed to facilitate the monitoring and, if necessary, coordination of those policies that are still basically conducted at the national level.

At the centre of this monitoring and coordination process lies the EU's Broad Economic Policy Guidelines, which set out general orientations for the conduct of economic policies in the individual Member States, covering areas such as public finances and tax policy as well as structural reform and market regulation. While these Guidelines are not binding in themselves, their elaboration and discussion in European institutions and fora in which each of the Member States is represented usually creates sufficient peer pressure to galvanise governments into appropriate policy action.

While monitoring and peer pressure are very effective tools for assuring that the various economic policies of the Member States move in the right direction, specifically in the area of budgetary policy, the EMU framework not only specifies commonly agreed targets, but also sets a binding upper limit for Member States' budget deficits of 3% of the gross domestic product (GDP). The failure of any Member State to respect this upper limit automatically triggers an excessive deficit procedure under which, if the deficit is not corrected in time, sanctions can be imposed on the Member State concerned. The relative rigidity of the rules governing the conduct of budgetary policy, when compared with other economic policies, is no accident. In line with what I said earlier, these restraints serve the purpose of preventing individual Member States from pursuing unsound budgetary policies, which - perhaps more than any other type of policy - might otherwise hamper monetary policy and impact negatively on the market's perception of the euro area as a whole.

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Having emphasised the importance of sound budgetary and structural policies, let me now turn to a subject which is even closer to the heart of a European central banker, namely the role of the single monetary policy in the euro area. In contrast to the economic pillar of EMU, there is, of course, only one monetary policy and, in formulating and conducting this policy, the Eurosystem has one overriding or, as the Treaty establishing the European Community calls it, "primary objective" which is to maintain price stability over the medium term. For this purpose, price stability has since been defined by the Eurosystem as a year-on-year increase of less than 2% in the Harmonised Index of Consumer Prices in the euro area as a whole. Anything above (inflation) or below this (deflation) is considered to be inconsistent with price stability. Price stability is to be maintained over the medium term. Given the long lags with which monetary policy impacts the price level, short-term movements in the price level, due, for instance, to volatile movements in commodity prices, cannot be controlled.

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Talking with hindsight, after one year of experience since the successful launch of the euro on 1 January 1999, the most important challenge to the Eurosystem was the definition of the appropriate monetary policy for the euro area as a whole. In this respect, the Eurosystem had to navigate uncharted waters, since it could neither build upon practical experience with policies for the euro area as a whole nor on any reputation of its own, although it could draw upon the reputation and experience of the national central banks. In fact, apart from theoretical considerations and econometric test runs, we had - in that sense - to start right from scratch. The complexity of this challenge can easily be derived from the fact that the Eurosystem has to define a single monetary policy for a quite heterogeneous area that, as mentioned earlier, stretches from Lapland in the north of Europe to Andalusia in the very south.

From a US point of view, this might not appear particularly demanding. The Federal Reserve System has always been confronted with the challenge of defining a single monetary policy for an even larger and likewise not fully homogeneous area. However, there seems to be a substantive difference. The US economy has evolved over decades, even centuries, under the conditions of the specific political set-up of the United States. This has not only created, regardless of existing differences at the state level, a common legal environment, but also led to harmonised or similar policies in most other areas and not least fostered the development of a common ground of behaviour in economic life. By contrast, the history of the 11 Member States of the euro area was different. Notwithstanding my earlier reference to the integration process over the last decades and the EU institutional set-up for the coordination of economic policies, Europe is still a more heterogeneous area than the United States.

The Treaty establishing the European Community does not state how price stability is to be maintained. In other words, it does not define what is called a monetary policy strategy. Therefore, the Eurosystem has designed its own stability-oriented strategy. Apart from the quantitative definition of price stability, it consists of two pillars. The first pillar is a prominent role for a broad monetary aggregate, M3. This is based on the view that inflation is ultimately a monetary phenomenon. A reference value of 4½% for annual M3 growth has been defined. Deviations of actual monetary growth from the reference value will not be corrected mechanically, but will always be analysed with regard to the signals they provide with regard to future price developments. The reason for being cautious is that the introduction of the euro may have changed the behaviour of economic subjects, also their demand for money. This is also the reason for not only looking at monetary developments and introducing the second pillar in our strategy. This pillar is a broadly based assessment of the outlook for price developments and risks to price stability. In this context, a host of indicators is analysed, such as interest rates, the output gap, exchange rates, wage developments, developments in public finance, asset prices and surveys of consumer and business confidence. The Eurosystem also examines forecasts of the economic outlook and produces such forecasts itself. They are one piece of information in the second pillar. On the basis of both pillars, central bank interest rates are set at the level which is deemed to be appropriate to maintain price stability in the medium term.

Defining the appropriate stance of monetary policy for an area the size of the euro area remains particularly challenging. On the other hand, experience over the last year has clearly demonstrated that there are no insuperable impediments to the conduct of a truly single monetary policy for the euro area. This is underpinned by the proven ability of the Eurosystem to act decisively, noted by its decisions to cut interest rates in April and to raise them in November. At the same time, this is also evidenced by the prevailing climate of price stability, with price increases of around 1% for the euro area on an average annual basis. The outlook for price stability is also favourable, although inflation is expected to rise somewhat in the near future. This is mainly a result of the recent strong increase in energy prices.

The fact that regional discrepancies in price increases amounted to up to 2 percentage points does not, by any means, conflict with this assessment. This phenomenon, which is almost typical for large-sized monetary areas and is also to be found in the United States, can reasonably be explained.

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So far, I have limited myself to considering the internal aspects of EMU, but the introduction of the euro also has implications that extend far beyond the boundaries of the European Union. As the currency of an economic area with a population of nearly 300 million people and one sixth of the world's gross domestic product (GDP), the euro is already the second most widely used currency in the world after the US dollar. Moreover, as investor confidence grows and as more EU Member States join the euro area, in particular following EU enlargement, the euro's role as an international currency is destined to gain in importance.

This is not to say that the Eurosystem will actively promote an international role for the euro, or that there is a policy of trying to supplant the US dollar as the world's leading currency. Rather, by adopting a neutral stance, the pace with which the euro acquires its international role - whether as a trade currency, an investment currency or as a reserve currency - will be left primarily to market forces. However, if the Eurosystem is successful in maintaining price stability, confidence in the single currency will automatically foster the euro's international role.

The exchange rate of the euro is to be regarded, primarily, as the outcome of current and expected monetary and fiscal policies as well as of cyclical and other economic developments. At the moment, the European economy is clearly recovering and the outlook is favourable, with economic growth accelerating in the direction of 3%. As a result, the euro has a strong potential for appreciation. This is also firmly based on internal price stability and a sound current account position.

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Before I draw to a close, allow me finally to return to another of those peculiarities of EMU that can sometimes confound the external observer. If any of you have travelled to a euro area country over the past 12 months, you may have been misled into thinking that what you saw change hands were not euro, but rather French francs, Deutsche Mark or Italian lira. In that case, you would be only partially correct. While national banknotes and coins remain in circulation for the time being, they are no longer, despite appearances, actual currencies in their own right. They are, in fact, sub-units of the euro, waiting to be replaced by euro banknotes and coins as soon as these are introduced at the beginning of 2002. Only then, I suppose, will we have finally completed one of the greatest achievements in modern European history that is the introduction of the euro.