Klaus Liebscher: The euro - one year on

Address by Dr Klaus Liebscher, Governor of the Oesterreichische Nationalbank, at the European Banking & Financial Forum 2000, held in Prague on 28-30 March 2000.

*   *   *

Ladies and gentlemen,

More than one year has passed since the start of the European Monetary Union. The introduction of the euro has certainly been a historic step in the process of European integration; moreover, it has substantially changed the international monetary system. The euro was launched as the new common currency of 11 participating EU Member States and, undoubtedly, the newly created currency area has a considerable weight in the world economy: it accounts for a 22% share of world GDP, 20% of world exports and hosts the world's largest banking sector.

One year on, the euro has successfully stood its test, so well that we have gladly forgotten how difficult the process was that Europe had to undergo before the single currency saw the light of day. The experience of the first year shows that a fully functional money market developed quickly after the very successful conversion on 1 January 1999 - a market which has been much less volatile than the 11 money markets which merged into the euro market, even though the Eurosystem, consisting of the ECB and the 11 participating national central banks (NCBs), has in essence used only two operation techniques: open market operations and minimum reserve operations. Since its inception, the single monetary policy has successfully guaranteed a stable price level, despite soaring oil prices in recent months, and at the same time it has notably contributed to non-inflationary growth in the euro area. Already during the first year of its existence, the Eurosystem has proved its determination and has shown itself to be an institution that is unerringly and consistently committed to its primary objective, price stability.

Given the size and the economic clout of the single currency area in Europe, the stability-oriented institutional framework of EMU and the growing integration of the financial markets of the participant countries, the euro stands every chance of becoming a currency of global importance. And in fact, the euro rapidly established itself as one of the leading investment, trading and issuing currencies. The euro is one of the principal currencies on the forex markets, and euro/US dollar trade is by far the most active trading segment. In addition, the euro has become a premier issuing currency.

According to preliminary statistics, euro-denominated bonds accounted for some 45% of new issues in the year 1999, which is roughly the same market share as that of new USD-denominated bonds.

All in all, the first year of the euro's operation has indisputably been a success. Of course, one year is too short a period to allow a final judgement. Economic and Monetary Union and the single European currency are meant to last - they are long-term endeavours.

Ladies and gentlemen, this conference is about the new and increasingly integrated Europe which has begun to emerge gradually over the last decade, and it is also very much about the future prospects of our continent. Let me therefore look beyond the confines of the Eurosystem and the European Union - and develop some thoughts about the role of the euro in the context of Europe as a whole. I would like to reflect on two connected issues that have to do with the approaching enlargement of the European Union, undoubtedly *the* crucial challenge to Europe in the course of the next years. The first issue is the role the euro plays in Central and Eastern Europe today, and will play in the future; the second issue is the nature of the link between EMU and enlargement.

In Central and Eastern Europe, several currencies which were replaced by the euro, above all the Deutsche mark, traditionally played a key role. The euro has assumed this role since the beginning of last year. The single currency has become particularly important as a unit of account in international goods and service trade in Central and Eastern Europe. Moreover, the euro is likely to play an ever larger role as an investment and issuing currency for private users in the Central and Eastern Europe and, in the longer term, for pricing of goods and on the stock exchange.

For the monetary policies of Central and Eastern European countries, the euro is a key currency already today. In most of the monetary policy strategies of Central and Eastern Europe, exchange rates play a vital role and, wherever they are not a formal or informal intermediate target, they are at least a key monetary policy indicator. In nearly all cases it is the euro upon which the Central and Eastern European currencies are oriented, or to which they are formally linked. In the case of the managed float countries, among them the Czech Republic, this is reflected by the fact that since the beginning of 1999 all these countries have been using the euro as a reference currency.

The countries which avail themselves of an exchange rate peg - be it a standard fixed peg, a crawling peg or an exchange rate managed by a currency board - mostly peg their currency to the euro only or to a basket in which the euro predominates.[1] The trend to use the euro as an anchor currency is becoming ever stronger, as Hungary's recent move from a euro/US-dollar basket to a clean euro link within the framework of the country's crawling peg regime shows, and will continue to strengthen further in the upcoming years. As a result, the euro will also gain importance as an intervention and reserve currency in the region.

Ladies and gentlemen, the Central and Eastern European countries which are involved in accession negotiations with the European Union are confronted with the basic question of how Economic and Monetary Union features in the overall context of enlargement.

As far as we can judge today, we see the economic and monetary policy integration of the candidate countries proceeding in three steps. In a first step, the candidates will accede to the European Union, then they will participate in the ERM II, the exchange rate mechanism of the Union, and finally, they will introduce the euro as their national currency. Let me concentrate primarily upon the first of these three steps, thereby focusing upon those tasks the candidate countries are facing today and will face in the near future.

In the period leading up to accession, the applicant countries will be confronted with two challenges. First, the accession candidates will have to fulfill the economic conditions for membership in the European Union, as defined by the European Council in Copenhagen back in 1993. These conditions consist in establishing a functioning market economy and attaining sufficient competitiveness to participate in the single market. Fulfillment of these conditions will allow the accession countries to integrate successfully into the economic and monetary cooperation within the Union just like those incumbent EU Member States which have not yet entered the euro area for the time being.

Let me make very clear that fulfillment of the Maastricht convergence criteria is not a prerequisite for membership in the European Union.

Still, a reasonable degree of macroeconomic prudence is essential in the run-up to EU accession, as stability-oriented policies facilitate structural change and foster the catching-up process in Central and Eastern Europe. In this context, it is important to underline that there are no institutional constraints on exchange rate policies during the preaccession period. Any exchange rate regime is feasible during this stage, provided that it contributes to and is embedded in an overall set of policies that is sound and effectively geared toward stability.

Coming from Austria, I clearly have an affinity to pegged exchange rates, as my country acquired excellent experience with a tight link of its currency to the Deutsche mark for a very long time. Nevertheless, I acknowledge that alternative monetary strategies, as for example the direct inflation targeting/floating exchange rate framework the Czech National Bank has adopted, can be equally suitable and appropriate during the preaccession period. In fact, it cannot be emphasized strongly

[1] Only two small Baltic Republics, Lithuania (which pegs its currency to the US dollar under a currency board arrangement) and Latvia (which pegs to the SDR) are exceptions. Both countries plan to switch to a euro peg, Lithuania in the second half of 2001 and Latvia once it joins the EU.

enough that a rigidly fixed peg can only be successful under very strict conditions - and this is particularly true in today's world of high capital mobility. What really matters is not the exchange rate regime as such, but the consistency and soundness of the policy mix as a whole. Experience shows that stability-oriented policies underpinned by wide-ranging structural reforms contribute substantially to limiting exchange rate variability.

The second challenge in the run-up to EU accession is to meet those legal standards of Economic and Monetary Union that are applicable to all EU Member States. This means that applicants will have to create the legal preconditions for central bank independence, prohibit direct financing of budget deficits by the central bank and end public authorities' preferential access to financial institutions. A further prerequisite for EU membership is full liberalization of capital transactions.

Among these legal standards, let me explore the issue of central bank independence in a little more detail, as this is one of the basic building blocks any country that intends to join the European Union has to put in place. What does the European Union mean by "central bank independence"? Basically, it is independence from other authorities, in particular political authorities, in the conduct of monetary policy and, more broadly, in the performance of all the tasks that are related to the ESCB, the European System of Central Banks, in which the central banks of all EU Member States participate. Central bank independence is essential for the credibility of the European System of Central Banks and for the effective conduct of a stability-oriented monetary policy. Independence has three main dimensions - the institutional, the personal and the financial dimension.

Institutional independence primarily means that central banks are prohibited from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. Likewise, rights of third parties to approve, suspend, annul or defer central bank decisions on ESCB-related tasks are incompatible with the EU Treaty. The same is true of any rights to censor such decisions on legal grounds.

Personal independence is about ensuring tenure for members of the ESCB's decision-making bodies by minimum terms of office and giving protection against arbitrary dismissal. To make this latter aspect more concrete, a central bank governor may be relieved from office only if he or she no longer fulfills the conditions required for the performance of his or her duties or if he or she has been guilty of serious misconduct, with the possibility of appeal to the European Court of Justice.

Financial independence, in essence, denotes that central banks have to be in a position to avail themselves of the appropriate means to ensure that they can properly fulfill their ESCB-related tasks.

Those applicant countries which engaged in accession talks with the European Union in 1998 - among them the Czech Republic - already dealt, in detail, with the issue of central bank independence during the membership negotiations last fall, when the chapter "Economic and Monetary Union" was on the agenda. Progress in the candidate countries on this issue is being monitored very closely by the European Union at large and by the European System of Central Banks in particular.

Let me now shortly sketch the second and the third step of the prospective monetary integration of the Central and Eastern European applicant countries. Upon joining the European Union, the new Member States are bound to the fulfillment of a number of EMU-specific obligations: they obligate themselves to orient their overall policies, and specifically their economic and monetary policies, toward the objectives of EMU, and they must endeavour to make progress toward meeting the convergence criteria stipulated by the Maastricht Treaty. They participate in the economic policy coordination process within the EU, are compelled to avoid excessive budget deficits, and commit themselves to present convergence programs on a regular basis. With a view to their eventual participation in the euro area, these new members are expected to gradually adapt their monetary policy instruments to ESCB standards. EU membership also includes the obligation to treat exchange rate policy as a matter of common interest.

Among other things, this means that the newly acceding countries are expected to join the Exchange Rate Mechanism of the EU. They need not necessarily participate in this exchange rate system immediately upon joining the European Union, but, depending on the specific circumstances in the individual candidate countries, this step may also be taken later. The prerequisite for the last step -

adopting the euro and thus participating fully in EMU - requires sustainable fulfillment of the Maastricht convergence criteria. Fulfillment of the criteria is ascertained using a procedure set out in detail in the Treaty on European Union. One aspect of fulfillment is the maintenance of price stability as the primary objective of central banks.

Not only institutional and legal aspects as well as the principle of equal treatment, but also economic considerations strongly suggest the step-by-step procedure I have sketched out. Adopting the euro too early could place severe strains on such countries' economies, and perhaps even trigger substantial and lasting disturbances. Such a course of action would be in the interest neither of the current euro area members, nor of future members of the euro area.

Still, an early introduction of the euro is sometimes presented as a panacea to all the economic ills and in particular to the still existing structural weaknesses in Central and Eastern Europe. In my view, this is a grave delusion. Structural problems can simply not be solved by monetary policy measures, they have to be corrected by creating proper incentive structures, transparent rules and functioning institutions. All this takes time. Simplistic quick fixes or "shortcuts" will certainly not do the job, but will instead significantly add to existing difficulties.

Therefore, ladies and gentlemen, let me draw the conclusion that the key challenge facing the applicant countries in the next few years, consists in strengthening their market economies and their competitiveness by firmly pushing ahead with structural reform and by subsequently adopting the Community acquis in the process. Only on this basis will the EU candidate countries from Central and Eastern Europe be able to attain durable and sustainable macroeconomic stability, and only by taking these steps will they ultimately be able to fulfill, in a lasting manner, the prerequisites for participation in the euro area.