Christian Noyer: Lessons from the European experience with exchange rate and monetary policy co-operation

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the Third Asia-Europe (ASEM) Finance Ministers' Meeting, held in Kobe on 14 January 2001.

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Ladies and gentlemen, I am delighted to be given the opportunity to participate in this ASEM meeting today in Kobe. This is the second time that the ECB is taking part in this event of increasing importance for the economic and financial co-operation between Asia and Europe. I will discuss today with you which lessons of relevance to Asia might be drawn from the European experience in exchange rate and monetary policy co-ordination.

1. Institutional background

One crucial aspect of the ongoing process of globalisation is that, on average, international trade and financial flows are growing at a faster, sometimes a much faster pace than world GDP. This has posed and will continue to pose unique policy challenges. In particular, individual countries are increasingly susceptible to external developments and shocks. This implies an increased need for international co-operation, both at the global level and at the regional level, in order to mitigate the effects of the potential negative externalities associated with globalisation.

In this context, the various processes of regional integration (e.g. EU, NAFTA, MERCOSUR, ASEAN) should be seen as integral parts of broader multilateral co-operation, and not as a weakening of global surveillance. In fact, the spill-over effects transmitted from one region of the world to another via interest rates, exchange rates and equity prices, for instance, can be mitigated through closer regional integration. By reducing the relative degree of economic and financial openness of the regions concerned, such integration can be an effective instrument to shield them from external shocks, thereby obviating the need for trade or capital restrictions.

The European experience shows that regional integration can be beneficial in this respect. The euro area weathered well the economic slowdown and financial market uncertainties arising from the series of balance of payments crises seen between 1997 and 1999. Likewise, provided that the current economic slowdown in the United States does not develop into a hard landing, the euro area is expected to record in 2001 above-potential growth for the second year in a row.

To be sure, sheltering domestic economies from external shocks was not the primary consideration of European integration when it was initiated almost 50 years ago. Nor were the creation of the euro and the setting-up of the European Central Bank (ECB) objectives at that time. These are, in fact, only the latest developments in a long process of regional integration that started and is continuing with a strong political commitment.

This political dimension is essential in order to understand how the momentum was maintained over an extended period of time so as to achieve gradual progress towards ever increasing integration: from industrial co-operation through a customs union and a single market to Economic and Monetary Union. Having recalled this institutional background, I will focus in my remarks today on the policy and operational requirements of exchange rate and monetary policy co-operation in Europe.

2. Policy requirements

Consensus on the main policy objectives to be pursued over time has always been a key requirement for effective exchange rate and monetary policy co-operation in Europe. The objectives were, initially, *exchange rate stability* and, subsequently, the creation of a monetary union based on *price stability*.

A need for exchange rate stability arose in the 1970s, in the wake of the collapse of the Bretton Woods system. Stability was needed in order to minimise the risk of trade tensions within the European customs union at the time. This led to the creation of the European Monetary System's Exchange Rate Mechanism (EMS/ERM) in 1979. The need for exchange rate stability became even more acute from 1986 onwards, with the move towards the creation of the single market for goods, services, capital and people.

The completion of the single market involved the full liberalisation of capital movements within the EU at the beginning of the 1990s. This gave rise to a new policy requirement resulting from the so-called "impossible trinity", which implies that autonomous national monetary policies are incompatible with fixed exchange rate objectives in an environment of free capital movements. As a result, national authorities participating in EMS/ERM had to subordinate monetary and, to a large extent, fiscal policy to the achievement of exchange rate stability. This led logically to monetary union, with the creation of the ECB as a supranational institution and the introduction of the euro.

3. Operational requirements

While consensus on the key policy objectives pursued over time has been crucial for effective exchange rate and monetary policy co-operation in Europe, one should not play down the importance of operational aspects in the day-to-day management of the EMS/ERM. Three main lessons can be drawn in this regard.

First, the operational framework had to be *flexible* in order to withstand episodes of tension as well as to adjust to changing economic and financial market conditions. In the European experience, examples of tension and changing conditions were the episodes of US dollar misalignment in the 1980s and 1990s and the asymmetric shock caused by German reunification in the early 1990s. In the EMS/ERM, flexibility was ensured through fluctuation bands around central exchange rates, which were either narrow (+/-2.25%) or wide (+/- 6%) depending on the degree of convergence of the countries concerned. The system became even more flexible when a +/- 15% fluctuation band was introduced following the crises in 1992 and 1993. The possibility of adjusting central rates through "realignments" to be agreed by the ministers and governors of the participating Member States added to the resilience of the system.

Second, arrangements for regular *consultations* among all parties to the system were used, including mechanisms for *monitoring* economic, monetary and financial developments and for assessing policy responses. In Europe, peer reviews of domestic policies became increasingly demanding over time. As a result, the provision of mutual financial assistance was increasingly subordinated to compliance with the policy recommendations made in such reviews or in the context of "realignments".

Third, the operational framework made it possible to achieve exchange rate and monetary co-operation among countries with *different levels of economic development*. Nominal convergence proved to be consistent with real convergence, as the countries engaged in the catching-up process were committed to implementing the necessary structural reforms in addition to macroeconomic stabilisation measures and their economic weight was small compared with that of the so-called "core" countries.

4. Conclusions

A few *conclusions* of direct relevance to our Asian partners may be drawn. As experience with the implementation of the ASEAN and APEC arrangements shows, Asian countries are developing their own way of strengthening regional integration. This is the right avenue to follow. Indeed, Asian countries will succeed only if they set realistic objectives in line with their own regional conditions and the corresponding level of political commitment. This is what Europeans have done over the last 50 years. At the same time, the European experience could serve as a reference point for assessing the policy requirements and operational aspects of a process of regional integration, possibly including exchange rate and monetary policy co-operation. Finally, the European experience shows that a process of regional integration can and should be without prejudice to the broader process of globalisation or to multilateral co-operation within the current institutional framework of the international monetary and financial system.