Ernst Welteke: The introduction of the euro as a historic event

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the European American Business Council, Washington, 19 November 2001.

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I

Ladies and gentlemen,

It is an honor for me to be here in Washington today. I would like to thank you for your kind invitation, which gives me an opportunity to discuss European Monetary Union with so distinguished an audience. Before I come to my main point, I would like to assure you that I feel close bonds with the people of the United States in these troubled times.

If you type “historic event” into your favorite internet search engine, you will get about 40,000 responses. Well, of course, I did not check all the sites suggested, but be assured that there is quite a wide variety of “historic events”. The introduction of the euro was not among the top twenty hits of that search, though. In discussing the historic dimension of the introduction of the euro today, we are not exactly walking a well-trodden path. However, as I will make plain today, that introduction *is* a historic event.

II

The three large currency areas in the world — the United States, Japan and the euro area — together account for almost one-half of world output. Those three entities share a lot of similarities, but they are strikingly different in some respects.

In terms of population size, the United States and the euro area are quite similar, around 300 million people, while Japan is a little less than half that size.

In terms of the share in world GDP, Japan is less than 10 percent, the euro area comes out in the middle, at 16 percent, while the USA accounts for rather more than one-fifth of world GDP. Per capita GDP, however, in the USA and Japan is about 50 percent higher than the euro area’s € 20,000 per head.

Ranked by openness — external trade in relation to GDP — the euro area is the most open of the three large currency areas, with its current account roughly in balance. The USA comes second with a current account in deficit, and Japan has its current account in surplus.

Comparing the three areas with respect to the public sector’s share in the economy, the USA has the lowest government expenditure, it has the lowest public debt and for the time being a budget in surplus. While the euro area has made some progress in reducing the government deficit and debt, the continuing slump in Japan has led to a rise in both measures of the scale of the public sector's activity.

In the field of finance, the three large currency areas show different structures due to the traditions followed. Bank deposits as a medium of investment, and bank credit as a source of finance, predominate in Japan.

Investors and financiers in the USA clearly prefer the capital markets. The euro area is claiming the middle ground, with a certain tendency towards a more market-centered system.

Economic and financial integration is deepening fast. International trade has grown considerably during the last couple of years. Foreign direct investment flows have increased even faster. Portfolio investment has internationalized. Stock exchanges are moving more or less in sync.

Growth rates are dwindling simultaneously in all three large currency areas at this point in time. That has very much to do with the higher degree of global integration yet underestimated by many policy makers. Growth of global trade will probably diminish this year to two percent after 12 percent last year. Among the major regions in the world only China, the Middle East and Russia, including some neighboring countries, will show substantially positive growth rates. There is something like a global business cycle. However, there is no perfect synchronicity among different areas. Causes, consequences and repercussions are different in every currency area. Therefore, policy reactions have to vary.

The US business cycle is close to a technical recession. Remember, less than a year ago, forecasters wondered whether the USA would see a hard or a soft landing. The downward trend of the high tech industry, and the corresponding overinvestment in IT where prominent among the causes of the downward movement in growth rates. The savings rate rose abruptly and the labor market performed increasingly worse. After September 11, additional negative psychological impact has to be overcome.

The USA responded quickly. The Fed lowered interest rates, the federal government lowered taxes substantially. Firms and markets do adjust quickly. I have no doubt that the US economy will again show rising growth rates within a few months.

Japan — already in a prolonged recession — could not withstand this downward trend. Japan has to cope with an economy that is still recovering from the effects of the severe banking crisis that followed the bubble economy of the late eighties.

Finally, the Euro area business cycle followed the world trend more closely than was observable in recent years. This can be seen as an outcome of closer links due to increased foreign direct and portfolio investment. Growth rates diminished, employment gains came to a halt, and prospects for the next year have worsened over the last months. However, capacity utilization and sentiment are still higher than, for example, in the recession of 1993. Adjustments take place, although slower than in the USA. As usual, expectations adjust faster than production. For Europe, psychological factors are no less important than in any other currency area.

Different causes require different policy reactions. This is the first reason for varying responses of the three central banks. Another – equal important reason – is that they pursue different concepts. The Bank of Japan is in an exceptional situation, anyway.

The US Federal Reserve System was set up in 1913. In accordance with the Employment Act (of 1946) and the Humphrey-Hawkins Act (of 1978), it must pursue several objectives at the same time: economic growth in line with potential output growth, stable prices, a high level of employment and moderate long-term interest rates.

The European System of Central Banks is "the new kid on the block" among the large central banks. Since 1999, it has pursued its sole primary objective of price stability. Differences in objectives and in strategy are the main explanations of the perceived differences in response to the current situation.

For Europe, monetary integration is an event of historic dimensions. Joining forces to set up a common currency area promises prosperity and stability to 300 million people. The institutional features of the ESCB provide for a framework enabling it to keep this promise. The success of the euro is one of the driving forces for Central and Eastern European states to apply for membership in the EU.

It is not only in Europe that efforts towards regional integration are being made, including notions of, and moves towards, monetary harmonization. Such discussions are likewise topical in all five continents:

- A currency union between Russia and Belarus is the one that is most concrete at present. The two countries have decided to set up a currency union from 2005 onwards; at first, the Russian rouble will be their currency.
- The member states of the Gulf Cooperation Council have been contemplating an Arab Gulf currency for some time. To further that initiative, they have recently set up a committee to take charge of studying the necessary requirements. However, political, economic and financial convergence does not suggest the early introduction of a common currency.
- In South America, monetary integration is envisaged for the Mercosur countries from time to time; however, with economic developments in Brazil and Argentina diverging more and more, a currency union looks rather far away.
- The idea of developing an American currency union from NAFTA emerges now and then. Obviously, it has not been pursued with any real zeal up to now.
- Talks about a possible yen zone have come up regularly in Asia. However, although trade and financial integration is well advanced there, switching from dollar orientation to yen orientation does not look very likely at this point in time.

- Deliberations on forming currency unions between Australia and New Zealand, or in Africa, are in a very preliminary state, as the political will to cooperate is lacking. In Africa, however, with the CFA Franc zone and the South African Rand zone, two currency unions already exist.

III

European Monetary Union (EMU), which started on January 1st, 1999, has its origins in the 1970s, when the first plan of a single European currency was drafted. Not until the Treaty of Maastricht — signed in 1992 — was the notion of a European currency put into concrete form. EMU is to be completed six weeks from now, when euro notes and coins are circulated.

Monetary unions in Europe, however, are not unprecedented. Three of them were set up during the second half of the 19th century. Today's world resembles the 19th century world in certain respects.

In that age of industrialization, rapid international integration was witnessed. Transportation costs sank, and led to closer trade relations. Profound structural change was the result. As the European countries became more similar, their economies converged. In that environment, naturally, monetary integration was deemed helpful.

Today, we are in the age of so-called "globalization". Transportation costs, information costs and communication costs have come down tremendously. Structural change is taking place in the "information society".

Trade and investment relations are becoming ever closer. This is especially true of the European Common Market, where freedom of movement is guaranteed for people, goods, services and capital. The case in favor of monetary integration in Europe is compelling.

Let's have a look now at the 19th century currency unions in Europe, and find out what we have learnt. Just as drawing an analogy of the international setting is far from perfect, so is any comparison of the monetary unions themselves. We can, however, gain some useful insights from earlier experiences.

In 1865, the four sovereign states of Belgium, France, Italy and Switzerland - Greece joined a little later - set up the Latin Monetary Union. The union covered only coinage, and had no common central bank. It was originally constructed as a forerunner of a political union — which was never established, though.

The founding treaty was open to interpretation in several respects, and that leeway was extensively exploited. Overall, commitment to the treaty was weak. One country was able to finance its public deficit by printing - or rather minting - money. What made those altogether rather heterogeneous countries stick together for more than 60 years was basically the need to tap the French capital market.

The issue of the Scandinavian Monetary Union was rather different. Sweden, Denmark and Norway - all three countries now abstaining from EMU - pegged their currencies to one another in 1872. They aimed at economic, political and cultural cooperation. In some respects, the Scandinavian union was more weatherproof than the Latin union. The three countries pursued similar development strategies, they were export-oriented, and they showed great adaptability to exogenous shocks.

Today, we would speak of convergent economies. Furthermore, the union treaty only spelled out what had been practised before.

What made the Scandinavian Monetary Union fall apart (in 1931)? Against the backdrop of international banking crises, it seems as if the lack of a single monetary policy framework was one of the reasons. Monetary policy in the three countries gained an increasingly national flavor, as, first, a pre-World-War-One export boom hit the union asymmetrically. And so, a little later, did the war itself. Monetary policy diverged increasingly, until the union was formally terminated in 1931.

As a third example, let's have a brief look at the German Monetary Union of 1871. The ground for that currency union was well prepared. First, the German Customs Union had already created a common market, although that had been hampered by the existence of disparate coinage systems. Labor mobility in the common market was relatively high. Second, Germany had been united politically under the lead of Prussia. The Reichsbank Act of 1875 then established a unified central bank to complete the German Monetary Union. It introduced the German "Mark" currency one year later.

What are the insights to be gained from these stylized facts about three earlier experiences of European monetary unions? We can identify certain features of such unions that seem to be conducive to the stability, and the success, of a monetary union. The European Union took these experiences into account when designing EMU.

IV

A monetary union is intended to provide the participating countries with a stable monetary regime that ensures price stability and enables them to thrive. The Maastricht Treaty set up the European System of Central Banks, with the European Central Bank - the ECB - on top. Both the ECB and the national central banks are independent. Monetary policy decisions are taken by the ECB Governing Council, which consists of the ECB Executive Board and the Governors of the participating national central banks.

Unlike the centralized decision-making, the implementation of the single monetary policy is decentralized. National central banks provide the markets with liquidity, in accordance with the decisions of the ECB Governing Council.

The primary objective of the European System of Central Banks is to maintain price stability. The ECB Council defines price stability as an increase in consumer prices in the medium term of less than two percent a year.

Unlike earlier monetary unions in Europe, EMU was set up with a watertight monetary regime. We have one single currency, the euro. The ECB has the sole right to authorize the issue of banknotes. Troubles similar to those which both the Latin and the Scandinavian Monetary Union ran into, when the countries' central banks pursued divergent policies, cannot occur under the European monetary framework, where decision-making is centralized.

A common stability orientation of all policy areas, to which all member states are committed, is essential.

The second stability-ensuring institutional feature of EMU is the Stability and Growth Pact. It spells out how member states are supposed to ensure sound public finances, as the Treaty obliges them to avoid excessive deficits.

As long as national budgets are in order, there is no incentive for member states to pursue an overly lax monetary policy, with an eye to reducing the interest burden on their budgets. Wage policy is another national responsibility. Wage agreements have in general been settled in line with productivity advances. Low, and stable, inflation expectations reflect confidence in the Eurosystem's policy, and help in negotiating stability-oriented wage settlements.

Research in the field of optimum currency areas has come to the conclusion that the member states of a successful currency union need to be what is called convergent economies. Convergent economies allow for a unified policy; divergent economies require differentiating policies. Its relative homogeneity may explain why the Scandinavian Monetary Union, over a long period, was more successful than the less convergent Latin version.

The European Union has been developing a Single Market for more than half a century. The four fundamental freedoms - mobility of goods, services, people and capital - ensure that what had previously been a customs union became an integrated economic area. Convergence is progressing.

Entry into EMU was and is conditional on the fulfillment of "convergence criteria". Countries willing to join the monetary regime must display a "high degree of sustainable convergence". That is measured in terms of price stability, exchange rates, capital-market rates and sound public finances.

In a currency area, we have a "one-size-fits-all" monetary policy, and no exchange rates to cope with asymmetric economic shocks. Such shocks may occur despite the advanced state of convergence in the euro area. The countries of a monetary union are therefore in need of flexible goods, capital and labor markets. The EU member states are working to improve the flexibility of those markets. Insofar as price rigidities exist mobility, as ensured by the four basic freedoms, is called for.

Political union has, in the past, proved helpful in preserving the stability of a monetary union. The European Union is moving slowly but steadily towards that long-term goal. Its willingness to assume greater responsibility in the global context is encouraging in that respect.

Overall, European policy makers have created a monetary union that is designed to last. Features which, in former currency unions, proved destabilizing have been avoided in the design of EMU.

But institutional features alone do not guarantee EMU's success. Commitment to the Union, and a true European spirit, are called for. In the ECB Council, we show this European spirit. National interests are not relevant to the process of shaping monetary policy for the euro area — the euro area as a whole.

V

Ladies and Gentlemen,

At its start, the Eurosystem has seen a period of unprecedented price stability. In 1998 and 1999, consumer prices rose by only 1.1 percent; in the year 2000, the inflation rate, at 2.3 percent, ran a little above the two-percent ceiling, after the sharp increase in oil prices during 1999 and 2000.

This year, after peaking in May, at 3.4 percent, the inflation rate has been decreasing. In October, prices were 2.4 percent higher than one year before.

In the current environment of a weak world economy, the ECB Governing Council is expecting a further moderation of price movements. At its most recent meeting on November 8, the Governing Council decided therefore to cut rates by half a percentage point. It has lowered its key interest rates during this year by 150 basis points to 3.25 percent.

The ESCB has been assigned one main policy goal: keeping inflation in check. If possible without compromising price stability, it shall support general economic policiesThe reasoning behind this policy mandate is threefold.

First, there is a purely economic reason. Keeping overall inflation low is the best contribution a central bank can make to sound economic growth. Furthermore, inflation tends to modify distribution in an unfavorable way.

Second, there is the well-known principle of reaching a bundle of policy goals best if each institution is assigned only one of the goals. And, third, there is the argument based on democracy theory: once an institution is granted independence, it should be given a clear mandate in return.

A generally stable currency, and markets that trust the stability orientation of central banks, make for lower price increases at times of crisis. They also anchor inflation expectations at low levels. The larger currency area is able to cushion external shocks.

In its brief history, the Eurosystem has already dealt successfully with three external shocks and crises. We have seen the Asian crisis in 1997-99, an oil-price shock in 1999-2000 and, most recently, the terrorist attacks. Europe did not escape unscathed from all these events. However, the low level of turbulence *within* the euro area contrasts with sharper reactions to similar events in the period before EMU existed. This means that we have withstood what has been regarded as the worst-case scenario for the new currency.

The European currency area exhibits greater macroeconomic stability, to the benefit of all its citizens, and also to the benefit of the world economy at large. For this greater macroeconomic stability to become reality, convergence is of paramount importance. Economic convergence is a precondition for the "one-size-fits-all" monetary policy really fitting all the regions in the euro area. A currency union, both stable and beneficial, needs convergence in all three respects: nominal, real and structural convergence.

VI

The European single currency fostered stronger economic integration by means of foreign direct investment. In 1999, world FDI flows, at E 888 billion, were more than three times as high as in 1995. Intra-EU FDI flows grew significantly faster over that period. In 1999, they were five times the size of 1995. In addition, intra-EU direct investment has risen significantly since the start of EMU. In the year 2000, it actually rose by 50 percent. Today, intra-EU FDI accounts for one-quarter of world foreign direct investment.

FDI stocks show a similar picture. Intra-EU FDI stocks make up 22 percent of world FDI stocks. Almost one-half of the FDI stock originating in the European union is invested in another EU member state.

The FDI statistics clearly show, first, that economic integration in the EU is intense, and, second, that economic integration deepened fast after the introduction of the common currency. These observations are borne out by the trade statistics. About one-half of the external trade of the euro-area member states is intra-euro-area trade.

VII

It is in the financial markets that the benefits of a common European currency are to be felt most clearly. The implications of the euro are obvious: rising liquidity, deepening and widening of the money, bond and stock markets, reduction of transaction costs and abolition of currency risks. The euro speeds up financial market integration.

Correspondingly, the functioning of the European Monetary Union depends heavily on a high degree of financial market integration. Its smooth functioning enables monetary transmission to work. Progress in this field is tremendous, but more is yet to come.

Those parts of the European financial markets that are crucial to the transmission of the Eurosystem's monetary policy are already integrated to our satisfaction. The wholesale market for interbank liquidity in the euro area is now actually a single European money market.

In addition, European banks are interconnected in a common payment-system infrastructure. And improvements to the euro-area-wide payment system are being undertaken. A few days ago, the Bundesbank launched its new payment system RTGS^{plus}, which improves security, reduces liquidity needs and expedites settlements of gross payments.

Through this system, about 8,500 banks and credit institutions, including their branches all over the world, are accessible.

The most impressive progress, in terms of integration, has been witnessed in the euro-area bond markets. Yield differences among the government bonds of the different participants have narrowed from more than five percentage points before EMU to some 30 basis points nowadays. The remaining spread is mainly due to the varying liquidity of the papers issued. Currency risks or divergent monetary policies no longer disturb the euro-area-wide diversification.

In terms of outstanding amounts, the euro-denominated bond market is still significantly smaller than that denominated in US dollars. But in terms of new issuance, both markets are on a par. One reason for that is the sharp rise in the new issuance of corporate bonds. Here again, diversification within the euro area has increased. The issuers' nationality, as a determinant of the yield and performance of bonds, has been superseded by other factors, especially by a sectoral view.

Accordingly, investors in the equity markets have shifted their perspective from country benchmarks to pan-European sector benchmarks. European equity markets are still small compared with those in the USA. The market capitalization of domestic shares, as a ratio of GDP, reaches about 90 percent [2000]. The matching figures for the USA and Japan are 152 percent and 68 percent, respectively.

Equity markets in the Euro area are growing fast. The ratio of new issuance to market capitalisation averages over 4 percent. This is twice as much as has been achieved in the USA or Japan.

Further integration of equity markets in Europe is being hampered by the segmentation of both stock exchanges and clearing and settlement systems. A consolidation process has started, and should be fostered by legal harmonization in the field of financial services. The degree of integration in the banking sector is mixed. On the one hand, wholesale markets and investment banking are largely integrated. On the other hand, commercial credits and retail banking still operate in national, segmented markets. Only a few European banks created by cross-border mergers start to offer retail services at a standardized level for customers in more than one country.

The financial system in the euro area is still highly bank-dominated. At the end of last year, credit financing totaled about 108 percent of GDP. This is twice as much as in the USA. The same ratio holds for deposits. In the euro area, they account for 80 percent of GDP, while the US figure is about 40 percent.

However, capital markets are increasing in importance in the euro area. Disintermediation is gaining ground. Financial markets have boomed in recent years and investment banks (as well as non-bank financial firms like institutional investors, pension and investment funds) have enlarged their market share. Disintermediation will be enhanced by the need for pension systems to rely more on funded retirement schemes.

Disintermediation will change the transmission process. Basically, it is speeded up. And disintermediation will change the income structure of banks. A rising share of fees and dividends, at the expense of interest income, will increase the volatility of banks' income. Since capital markets are more integrated than the banking sector, disintermediation will foster the integration of the entire financial system in Europe.

Changes for the banking sector are in prospect once the new Basle Accord is applied. In general, we welcome the new accord if it helps to improve the allocation of capital. However, two special features of the German economy should be considered:

1. The German economy is largely dominated by small and medium-sized enterprises, known as the „Mittelstand".
2. Our financial systems rely to a large extent on long-term financing.

This long-termism of financing has contributed successfully to the stability and prosperity of our economy, as well as the financial system. That is why the Bundesbank argues that banking regulation should not discriminate against long term financial relations.

Small and medium-sized enterprises with a revenue of up to ϕ 5 million make up more than 95 percent of all enterprises in Germany. This „Mittelstand" forms the backbone of the German economy. However, their share of outside capital is significantly higher than with larger firms. A lower rating is therefore to be expected, unless other collateral or risk-lowering factors are taken into account. Here again, we favor a differentiated approach that does not put banks with a large disposure to small and medium-sized enterprises at a disadvantage.

Since we do not want the new Basle Accord to endanger the prosperity or stability of our economy, and our financial system, we have to convince our partners to agree to a more differentiated accord.

VIII

Let us share a few thoughts on the international role of the euro.

Three years into its life, the euro is the second most important currency in the world. It took over that role from the Deutschmark.

The euro has a share of roughly 13 percent in international currency reserves — about as much as the Deutschmark had before. In this field, the dollar is the unchallenged leader, at two-thirds of international reserves. The size, depth and liquidity of the dollar markets, as well as the widespread habit of using the dollar for interventions and for pricing commodities, explain its predominance.

As regards its use as a store of value, we find some evidence of the growing importance of the euro. 30 percent [at end-2000] of all international securities outstanding are denominated in euro. This share is slightly above the aggregate share of the predecessor currencies shortly before EMU was launched. That leaves the euro as the second-most-important currency in the international securities markets. Again, the dollar is the dominant currency, accounting for one-half of all international securities outstanding.

A look at the flow data underlines the growing importance of the euro as a means of international finance and investment. In its first year (1999) the euro was the most important currency for debt-securities issues that were aimed at the international market; in the year 2000, it fell back somewhat, to 40 percent.

The currency composition of international bank assets presents a similar picture. Again, the dollar is the leading currency, with a share of 40 percent, while the euro is in the process of catching up. From slightly less than one-quarter at the end of 1998, its share rose to 27 percent, twelve percentage points of which were intra-EU bank assets.

What can we see from these figures? Although habits in the international use of currencies change only gradually, the euro has already won a respectable market share. Its market share roughly equals the economic weight of the euro area.

Further progress in the development of broad, deep and liquid financial markets is a precondition for the expansion of the euro's international role. Increased international use of the euro, as a currency for international reserve holdings, for investment and financing purposes, might have some bearing on monetary policy, but this potential impact seems manageable. Hence, in the Eurosystem, we have adopted a neutral stance towards the internationalization of the euro. We regard it as a market-driven process, and we neither hinder it nor foster it.

IX

Ladies and Gentlemen,

For Europe, the introduction of the single currency is an event of historic scope. The launch of the European System of Central Banks came with a promise of stability and prosperity.

Stability must be earned, again and again, day by day. The German “Stabilitätskultur” - one may translate this as "stability culture" - is one of our most cherished exports to our European partner countries. European people now share a firm stability orientation.

Prosperity must likewise be earned, again and again, day by day. The Eurosystem can and does contribute by providing an environment of stability, where prices are fairly accurate indicators of relative scarcity. The ensuing efficient allocation of resources is a precondition for prosperity. However, other policy areas can - and must - do more in this respect than monetary policy.

People in the European Monetary Union hold on to the single market and the single currency, because they know it is good for them - individually - and also for their countries. This, ladies and gentlemen, is why I expect a long life for the European version of a currency union, as shaped in the late 20^{th} century.