

## **Willem Duisenberg: China and the euro area in a global perspective**

Address by Dr Willem F. Duisenberg, President of the European Central Bank, at the symposium of the People's Bank of China, Beijing, 25 February 2002.

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Governor Dai, ladies and gentlemen,

It is a great pleasure to be here in China and I feel especially honoured to be invited to deliver a speech at the People's Bank. First, I would like to wish you all a very prosperous new year, under the sign of the horse. I would also like to take this opportunity to thank Governor Dai and his staff, among other things, for their hospitality and for having prepared such an excellent programme for our delegation.

Ever since China opened up to the outside world in 1978, it has been a major trading nation thanks to social and economic reforms. The process has turned China into a major economy and strengthened it as a political power. In 2000, the size of the Chinese economy, measured in terms of GDP, passed the USD 1 trillion mark, and is now ranked fifth behind the United States, the euro area, Japan and the United Kingdom. To accompany China's growing economic and financial weight in the international community, the EU is committed to further developing a comprehensive partnership with this country. The ECB is playing its part through co-operation in both international and bilateral meetings. For example, we meet regularly with other central banks in the context of the IMF, G20 and BIS to exchange views on global economic and financial issues. In fact, I have already met Governor Dai once this year (actually, last week) in Hong Kong, at a BIS Special Governors' meeting. Europe and Asia also co-operate closely through the ASEM (Asia-Europe meeting) process, launched in Bangkok in 1996. This has now developed into a broad forum for in-depth consultations between European and Asian partners and has prompted a range of co-operation initiatives. For example, in April this year the ECB will be organising a seminar on "Regional economic, financial and monetary co-operation: the European and Asian experiences". Of course, I would also like to recall that the EU has long been in favour of China joining the World Trade Organisation, as it now has done, for which I should like to congratulate you.

On a bilateral basis, four summit meetings between the EU and Chinese leaders have been held since 1998. Leaders exchanged views on EU-China relations as well as international and regional issues of common interest, and agreed at the fourth summit in 2001 that the EU and China should continue their efforts to promote stability, peace and development in the world. Meanwhile, 2001 also witnessed a strengthening in the relations between the ECB and China. Following the visit of the PBC delegation headed by Governor Dai to the ECB in June, we agreed to establish a regular dialogue between the two central banks so as to enhance our co-operation on issues of common interest. Towards the end of the year, our Vice-President, Mr. Noyer, was invited twice by the Delegation of the European Commission in China (once to Beijing in November and once to Shanghai in December) to speak on the subject of the euro cash changeover. On those occasions, Mr. Noyer outlined the importance of the process for the whole world, and reviewed relevant issues for countries outside the euro area.

Today, I would like to dwell on the same topic – the euro. Let me begin by giving you an update of the euro cash changeover. I will then talk about the recent global economic developments and their impact on the euro area, before turning to the international role of the euro.

### **Euro cash changeover**

Let me first turn to the introduction of the euro banknotes and coins. While the euro was introduced as a new currency on 1 January 1999, the euro banknotes and coins were only issued and became legal tender in the countries participating in the euro area at the beginning of this year. With the cash changeover, the process of introducing a single European currency is completed. Paying with a single currency in daily transactions throughout the euro area can be regarded as an achievement of historic proportions and as a major step towards greater European integration.

Now, three days before the remaining national currency denominations will cease to be legal tender, I can say that the operation has progressed very smoothly and successfully, even beyond our expectations.

The introduction of euro banknotes and coins has been a complex and ambitious undertaking. In addition to understanding and collaboration on the part of the public, it required organisational, logistical and technical efforts on the part of those sectors directly involved in the use of banknotes and coins.

By the end of 2001, more than 6.4 billion euro banknotes worth some EUR 133 billion and amounting in volume to around 80% of the euro banknotes now in circulation had been frontloaded (i.e. pre-delivered) to banks. With regard to the euro coins, more than 37.5 billion coins or 90% of the coins now in circulation with a total value of around EUR 12.4 billion had been frontloaded. Broadly speaking, sub-frontloading – the pre-delivery by banks to retailers and other professional target groups – represented an overall amount of 10 to 20% of the frontloaded amount.

Given that, in terms of transactions, around 70% of banknotes are put into circulation via automated teller machines (ATMs), the quick adaptation of these machines was one of the key factors for a smooth changeover. In total, more than 200,000 ATMs either on site in bank branches or off site, for example in shopping centres, had to be converted. This was achieved within less than one week. As a result, on average, 75% of all cash transactions were already effected in euro after only one week. On the whole, the euro banknotes and coins were introduced considerably faster than originally foreseen, not least because of the favourable attitude of and quick acceptance by European citizens.

I should like to mention that the changeover has also been smooth outside the euro area. The euro banknotes were received positively in third countries. Information to the public has been generally adequate and euro banknotes were readily available in banks and exchange offices, in most cases.

With regard to the frontloading of central banks outside the euro area, I should mention that 26 central banks, mainly in central and eastern Europe, the Mediterranean area and in Africa, requested to be frontloaded with euro cash. The total value of the euro banknotes provided to these central banks and to wholesale banks outside the euro area amounted to some EUR 4 billion.

Overall, the Eurosystem is proud of and grateful to all actors' contributions to this historic process. The enthusiasm of the European citizens to get hold of euro cash can be seen as a clear vote for a united Europe.

### **Recent global economic developments**

Let me briefly review the current international environment. I feel quite some relief that the world economy has proved relatively resilient to the shock of the terrorist attacks in September of last year. The events of 11 September and their aftermath undoubtedly increased uncertainty, and for some time contributed substantially to the already ongoing deterioration in confidence in most countries.

However, there are now more and more signs that the global economic downturn may have come to an end around the end of 2001. At the current juncture, a mild recovery is generally expected to start in the course of 2002 and to accelerate in 2003. The risks previously envisaged in connection with the 11 September events appear to have largely evaporated. Nevertheless, the level of uncertainty on the precise timing and strength of the recovery remains high. While I am reasonably optimistic about the sustainability of the recovery that, we expect, will start this year, I am also aware of the remaining downside risks.

These risks relate, for instance, to the imbalances that have built up during the past episode of exceptionally strong growth in the world economy and have only been partially corrected. Examples of these imbalances are protracted current account deficits, household and corporate indebtedness, overinvestment in certain industries, and fragility in the financial sectors of some countries. In that context, an important issue is the extent to which trade will finally pick up from the historical lows witnessed in the second half of 2001, and how beneficial the international transmission mechanism will be in transforming the current limited signs of recovery into a virtuous circle for world growth. Needless to say that protectionism and, more generally, obstacles to further international trade integration would be counterproductive also in this respect. In this context, I think we all agree that China's entry into the WTO has been a significant step towards further progress in world trade development.

### **Economic outlook for the euro area**

Let me now turn to the economic outlook for the euro area. Overall, 2001 was a rather disappointing year with regard to macroeconomic performance: growth in activity was below potential and consumer

price inflation was above the 2% limit set by the ECB for price increases over the medium term. This disappointing performance was the result of an unfortunate combination of adverse supply and demand shocks, originating to a large extent from developments in the external environment. These included the sharp increase in oil prices in 2000 and early 2001, the slowdown in the US economy and the terrorist attacks in the United States. Taken together, these adverse shocks led to a protracted weakening in demand – from both the external and the domestic side – and to considerable uncertainty with regard to the outlook for growth.

Looking ahead, we expect that the negative impact on growth and inflation from these adverse factors will diminish and that this will pave the way for a more satisfactory macroeconomic performance this year and next. Most recently, projections have shown that real GDP growth in 2002 as a whole should be somewhat lower than in 2001, but this would be consistent with a recovery in growth in the course of this year. At the end of the year, economic growth should reach a level close to potential growth. For the time being, however, the strength and the precise timing of this recovery remain uncertain.

A number of positive factors can be identified that should support the upturn in growth in the euro area. First, as regards the domestic side of the euro area economy, an important reason for expecting a recovery is that there are no fundamental imbalances that would require an enduring correction process. Second, as regards the external environment, there are some encouraging signs of a stabilisation in the outlook for growth at the global level, related mainly to positive news from the US economy. Other indications of an improvement in economic activity are that, owing to the ECB's stability-oriented monetary policy, financing conditions are now very favourable. Moreover, the declines in consumer price inflation observed in the second half of 2001 and expected over the course of 2002 will support higher growth in real disposable income, which, in turn, should underpin growth in domestic demand.

We continue to expect no medium-term upward pressures on inflation. At the same time, however, annual inflation rates in the euro area will be somewhat erratic at the beginning of this year. Preliminary HICP data for January 2002 saw an increase in inflation, which was due to a large extent to exceptional and short-lived factors. I should like to emphasise that, notwithstanding many anecdotal reports of price changes associated with the introduction of euro notes and coins, there is currently little evidence of any significant effect on the aggregate inflation figures. Barring unforeseen developments, the Governing Council expects that annual HICP inflation should fall safely below 2% during this year and remain at levels consistent with price stability thereafter.

### **International role of the euro**

Last but not least, I should like to address the use of the euro outside the euro area. The introduction of the euro has contributed to the emergence of a new economic player, the euro area. The euro area includes 12 countries and over 300 million people. It is also the largest trading partner in the world economy, accounting for 19% of world exports.

Let me explain how the European Economic and Monetary Union has modified global finance. I would like first to comment on the building-up of a new integrated financial market within the euro area, and then turn to some evidence on the role of the euro outside the euro area. I will finally explain why the two aspects (the domestic and the international role of the euro) are intertwined.

### **The euro and European financial markets**

The creation of the single currency is one step in the integration process in Europe, which started with the establishment of the European Economic Community in the 1950s. The integration among the Member States gained further momentum with the completion of the single European market in 1992. By the time the European Central Bank was created in 1998, capital movements in the EU were already completely liberalised, and commercial banks have been allowed to operate within the entire European Union since 1996. However, exchange rate fluctuations among the currencies of EU countries – although not close to the size of the wide swings in the early 1990s – still implied, if unhedged, currency risks for any EU-wide allocation of investment portfolios. Moreover, financial investors had to face very diverse levels of monetary stability and fiscal soundness across EU countries.

The success of the nominal convergence process – which preceded the start of Monetary Union – and the governments' commitment to honour the fiscal regulations associated with the monetary

integration itself, reduced risks of EU-wide investments even before the creation of the ECB. The irrevocable pegging of exchange rates and the effective start of Monetary Union on 1 January 1999 created an unprecedentedly large single financial area in Europe. Today, we have a single interest rate prevailing in the short-term financial markets and only minor spreads between long-term bond yields among the 12 euro area Member States. Since 1999 we have observed a surge in the dimension of our domestic financial markets: euro-denominated securities issued by euro area residents (other than shares) have increased by 20% to around EUR 7 trillion. New market segments – for instance, corporate and municipal bonds – have recorded strong growth. We have observed a market-driven integration process, through which stock exchanges have been linked to each other, by creating single trading platforms, and the settlement system infrastructure has been streamlined with the creation of cross-border hubs. Every day, the wholesale payment system for the euro (TARGET) processes around 200,000 large-value payments among credit institutions, 20% of which relate to cross-border transactions. The latter amounts to an increase of cross-border activities by more than 15% in the last two years.

### **The euro outside the euro area**

The significant size of domestic markets for euro-denominated assets has increasingly attracted financial operators outside the euro area. In particular, the euro has been used by international borrowers as a currency to secure funding. Let me give you two examples.

Since the launch of the euro, around one-quarter of international money market instruments issued by residents outside the euro area were denominated in euro. This is mainly due to the investors' interest in the higher liquidity brought about by the creation of the integrated money market. Before the launch of the single currency, only 8% of all international money market instruments issued by non-euro area residents were denominated in the legacy currencies.

Likewise, around 30% of international bonds and notes issued by residents outside the euro area are currently denominated in euro, as opposed to less than 20% in euro legacy currencies prior to 1999. Also in this case, market expectations of growing liquidity have probably been the key driving force behind the upward trend.

Let me add that, outside the euro area, the euro is not only used by private agents but also by the official sector. In particular, more than 50 countries currently maintain an exchange rate regime involving an external anchor in which the euro plays a role.

As a reserve currency, the euro accounts for 13% of official reserves and, admittedly, plays currently a smaller role than the US dollar, whose share amounts to 66%. The ECB itself, by holding a large amount of US dollar foreign reserves, contributes to the prevailing role of the US currency as an official reserve currency. The current share of the euro in international reserves is comparable with the share reached by the euro legacy currencies prior to the introduction of the euro, implying that, in aggregate terms, there had been no reallocation of official reserves out of the US dollar.

### **The link between domestic and international factors**

Let me now elaborate briefly on the interaction between domestic and international factors as a determinant of the international use of the euro. Without doubt, when deciding on the use of the euro or another currency as a means of transaction, international markets also assess economic policies carried out in the various economic areas. In this vein, the commitment of the ECB to price stability – which is defined as an inflation rate below 2% over a medium-term horizon – should underpin international investors' confidence that the purchasing power of their euro-denominated assets will be maintained over time. Indeed, a currency can only reach international status if internal price stability is ensured over the long run.

International investors also consider the size and liquidity of domestic financial markets as crucial. In this regard, efforts currently undertaken to further promote integration of financial markets (with more than 40 measures to be adopted by EU institutions) are likely to further attract international financial operators. Larger and more liquid financial markets imply lower transaction costs, and make it more efficient for foreign agents to trade euro-denominated financial instruments, as well as to resort to the euro in the foreign exchange market.

It is not the task of the ECB to try to influence directly the international investors' decisions regarding the currency in which they want to invest, borrow or lend. The international role of the euro will ultimately depend upon the market's judgement. However, this neutral stance of the ECB should not be misinterpreted, as the increasing use of the euro is an issue of policy relevance to the ECB, and requires continuous monitoring.

To sum up, the creation of the euro facilitates the deepening of the financial integration inside Europe. Moreover, the single currency has already had consequences outside the euro area, as the euro has rapidly become the second most used currency in the world.

## **Conclusions**

To conclude my speech, I will pre-empt the Q and A session by first telling you "What will happen after February?" From 1 March 2002, not only will the euro be the sole legal tender in the euro area, but it will also become one of the main channels that should facilitate the future co-operation between the ECB and the PBC. While China will manage to sustain strong growth and to open further its internal market as part of the WTO membership process, we expect the trade and financial ties between China and the EU to grow even stronger. I attach great importance to the relations between the ECB and the PBC, and I am very confident that such relations will flourish over time. "Xie Xie"