A Wellink: The Euro, a major challenge and catalyst for Europe

Speech by Dr A Wellink, President of De Nederlandsche Bank and President of the Bank for International Settlements, for the Dutch Business Round Table, Zürich, 12 March 2002.

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Introduction

It was in here in Zürich over 55 years ago that Winston Churchill held his famous speech on the future of Europe. He depicted a United States of Europe that would put an end to centuries of conflicts and bring prosperity to its peoples. Indeed, since then we have come a long way in actually fulfilling his grand vision, although without Switzerland - the nation he addressed - playing an active role.

Of course, there are many reasons - mostly of a historical -political nature - why Switzerland chose to stay outside the process of European integration. In this respect, I certainly do not want to pass judgement. Nevertheless, you find yourselves surrounded by an ever closer union of Member States that has also introduced a single currency. In this light, I would like to elaborate on the introduction of the Euro and it´s consequences for the European Union - taking into account, where possible - the position of this country.

First, I shall briefly touch on the actual changeover to the Euro at the beginning of this year. Then I shall go into the merits that monetary union already brought over the last few years. Finally, I will give my vision on future challenges and dynamics of the Euro.

Changeover

Ten years after the Treaty of Maastricht, the Euro finally found its way into the pockets of 300 million Europeans. This unprecedented process - comprising the distribution of 239,000 tonnes of coins and 2 million kilometres of notes - was an outstanding logistical success. Moreover, doom scenarios predicting mass forgery, robberies and threats to public security proved wrong.

Of course, a clear, central scenario and tight planning, especially within the European System of Central Banks, provided a firm foundation, but the operation remained highly dependent on local players; transporters, retailers, bankers, administrators, law-enforcers. In fact, there were also a number of Swiss companies (Lanqart (paper), OVD Kinegram) involved in developing and producing the high quality Euro notes. The efforts of these local players and the sheer public enthusiasm for the Euro were central to the success of the changeover. Indeed, through the sale of so-called eurokits, people on average had already 14 eurocoins in their pocket before 1 January. This “euro-eagerness” explains that by the first week, already 75% of cash payments were in Euro.

In the Netherlands, this 75% level was already reached on the second day, and after one week, the changeover was virtually completed. As such, it was not without pride that I proclaimed my country European champion - though that could not entirely wash down the bitter aftertaste of missing this year´s World Championship soccer. In hindsight, people felt well-informed about the Euro and found the Euro introduction in no way the drama that some had predicted.

Finally, on 28 January, the Dutch Guilder was the first of the former euroland currencies that in practice lost its legal tender status. To ease the minds of Dutch Roundtable members present, Guilders can - under certain conditions - still be exchanged for Euros at my central bank; coins until 2007 and banknotes even until 2032.

One tiny spot on the otherwise shiny, new currency is the anecdotal reporting of price changes associated with the changeover. There is, however, little evidence of any significant effect on aggregate inflation figures in the Euro area. According to the European statistical office, Eurostat, the effect is likely to fall within the range of 0.0% to 0.16%. On a country-by-country basis, the possibility to round up prices would, of course, be linked to the conversion rate of the national currency. For example, calculating back from Euros to German Marks is much easier than from Euros to Dutch Guilders. In addition, the cyclical position of the economy would influence the direction in which rounding may have occurred.

For the Netherlands, our research suggests that there might have been a slight upward effect on the price level of 0,2% to 0,4%. Overall, competition and peer pressure from consumer organisations would clearly limit room for manoeuvre. Moreover, possible one-off effects will be more than compensated by increased price transparency over the years to come.

The merits of the Euro so far

This brings me to the reasons why the Netherlands decided to give up its beloved currency. Foremost, the Euro is a political project in which the Dutch could not afford to stay out. Integration in a supranational context protects the interests of smaller European players.

In economic terms, the Euro increases macro-economic stability and cross-border price transparency. It reduces transaction costs by eliminating exchange rate risks. Moreover, the Euro is a catalyst for further economic reform and integration. In this respect, the economist Andrew Rose recently published an interesting article on common currency arrangements. Using cross-country panel data, he shows that countries with the same currency, trade substantially more than those with different currencies. Interestingly, the impact of a common currency is also larger than of a fixed exchange rate regime, which reduces volatility but retains separate monies.

In this light, the Euro is the icing on the internal market cake by broadening and deepening its scale. But, as always, the proof of this cake is in the eating. Indeed, the three years of the Euro´s virtual existence confirm the Dutch political and economic motives. Though some tend to be misled by its exchange rate, the Euro has proven to be rock solid with low inflation and, with it, a credible European Central Bank. Now, with hard currency in hand, the public will become more aware of the fact that a Euro is a Euro, and that the internal stability of the Euro counts. Stable price developments and a low level of long-term interest rates provide a firm basis for growth.

In addition, the Euro ended once and for all the uncontrolled spending dynamics of the past. Indeed, the EU is unique in having set itself a standard for sound government finances through the Stability and Growth Pact. In this light, you probably all heard about the early warning that the European Commission recommended for Germany and Portugal. As a consequence, both countries strongly re-committed themselves to budgetary consolidation and the close to balance rule of the Pact. The outcome clearly reflects the respect of all countries involved for the Pact, and underlines the credibility of the macro-economic policy framework in general. Thus, the Euro has offered a stable environment both to governments and business.

Finally, the Euro has already made a spectacular impact on financial markets in Europe. These have become broader and deeper, with a sharp rise in both the volume of capital issues and the spread of credit quality. Compared to 1998, total international bond issuance in Euros have more than doubled, and now compares well with the level of dollar-bonds. The sharp rise in the corporate bond market has increased financing possibilities and enhances merger & acquisition activities in Europe.

Switzerland and the Euro

Being closed in by Euro-territory, the Swiss can also reap the Euro fruits, all be it partly, in terms of bigger investment and borrowing opportunities in the Euro-market. In addition, the trading environment has improved with more price transparency in comparing potential trading partners and less exchange rate risks. On the downside, potential exchange rate volatility remains, as you have experienced between the Frank and the Euro.

Given that business services and tourism are central to the Swiss economy, there is no doubt that Euro coins and notes will increasingly pop up cross border. Indeed, large retailers appear to accept Euros and a large number of cash dispensers in major cities and at the border produce Euro notes. I heard that in this city even ticket machines for car parks are made “euro-fähig”.

Some point to a possible parallel use of the Euro in economies surrounding the Euro area. In fact, it was the British that first introduced the notion of a parallel currency back in the early seventies, and again during negotiations at Maastricht. As an alternative to monetary union, they wanted the intangible European Currency Unit to compete with the national money. Should the European currency prove stable and successful, it would by the laws of nature become the sole legal tender. Along these lines, Helmut Kohl argued recently that Switzerland would adopt the Euro in 2010 at the latest.

However, I think that mature countries such as the UK, Sweden or Switzerland, are not likely to take on the Euro as national currency without further political integration with the EU. In other words, they will have to be part of - and committed to - Economic and Monetary Union. Here, we can draw a parallel with, for example, the limited role of the US dollar in Canada - despite the relative economic weight of the US and strong trading relations in the context of the North American Free Trade Area.

Future challenges and dynamics of the Euro

It appears, I am already looking into a crystal ball, so let me move on to the future challenges and dynamics of the Euro for Europe. The dynamics of the Euro clearly lie with the expectations and pressures of markets and the public opinion at large. A good example is the recent agreement in the EU that the costs of cross border bank transfers should be substantially reduced. In a similar vein, economic agents simply do not accept that cross border security transactions are more expensive than within the US. Therefore, the European Parliament recently accepted the report, prepared under chairmanship of Baron Lamfalussy, that foresees in speeding-up decision-making on the elimination of barriers in the European security market. This plan is part of an ambitious EU programme to create a truly integrated financial market by 2005.

This political spin-off is not limited to the EU alone. For example, the European Commission has recently opened discussions with Switzerland, and other third countries, on banking secrecy and the fiscal treatment of savings. I understand that on the Swiss side, this sensitive dossier has been linked to other fields of negotiations such as Schengen and European immigration policy. It goes to show that even in third countries the impact of the Euro surpasses the economic domain.

Clearly, the Euro enables the “E” of EMU to reach the critical mass necessary for progress in many policy areas. In that sense, a further deepening of financial markets will enhance labour mobility, for example through the portability of pensions and social security entitlements across borders. More importantly, there are signs that labour market flexibility has been improving. Thus, the European labour force tends to absorb cyclical fluctuations more effectively. In a similar vein, wage negotiations appear to adjust faster to changing economic conditions, while inflation expectations have decreased. This change in behaviour is a reflection of the fact that in the Euro-countries exchange rate flexibility is no longer available to neutralise structural deficiencies.

The extent of success is determined by one, major factor - European policy makers must recognise the Euro dynamics and live up to the expectations of long-term integration. Here lies the central challenge that follows from the introduction of the Euro: Politicians have to deliver. In that sense, the European Council, that convenes in four days´ time in Barcelona, will have to put its political weight behind the liberalisation of the energy market and the deadlines of the Financial Services Action Plan. Moreover, the Council should be committed to - for example - the speedy adoption of the European take-over and patent directives, both of which have been on the table for decades.

Conclusion

Let me conclude. A representative of the Deutsche Bank recently said that ´there has been a lot of positive Euro speak in the last couple of years, but nothing that has led to better growth´. I disagree; the virtual Euro has brought macro-economic stability and increased dynamics in the internal market, the financial market in particular.

Moreover, the changeover to the tangible Euro has been a major success thanks to the great acceptance and enthusiasm around Europe for the common currency. The historical and political importance of the Euro for “an ever closer union among the peoples of Europe” (preamble Treaty of Rome) is without any doubt.

However, I agree that one needs to put the money where the mouth is. The benefits of the Euro can only be reaped to the full if its dynamics are acknowledged. In this respect, the Euro is a catalyst for more growth and employment, while it is a challenge for European policy makers to shape the right climate.

In a way, the Swiss also face this challenge - the more, now that the EU is on the brink of a sizeable enlargement. Following Winston Churchill´s address here half a century ago, the time might come when sensitive questions on sovereignty and neutrality no longer tilt the balance against playing an active role in Europe. In fact, an historic breaking point might have been reached with the recent, public majority support for membership of the United Nations. Should Switzerland ever decide to take part in European integration, I am convinced that you will embrace the Euro as warmly as the Dutch did on 1 January.