Christian Noyer: From Maastricht to the present and beyond

Speech by Mr Christian Noyer, Governor of the Bank of France, at the GIC / Drexel Spring 2007 Conference, Philadelphia, 16 April 2007.

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We have just passed the European Union 50th anniversary. It is a good time to reflect upon the essence and future of this extraordinary endeavor. Never before, in the whole history of mankind, have democratic nations pursued and reached, through peaceful cooperation, such a close degree of interdependence, involving, in many crucial areas, deliberate pooling of sovereignty. Of course, the process has not been without difficulties and tensions, many of which are still apparent and acute. Of course, numerous challenges remain and the future is paved with roadblocks which could still derail the whole project. But, for the first time in more than a thousand years, Europe is at peace and prosperous, with democratic regimes everywhere. This is, by historical standards, an exceptional achievement.

At the start, EU was built on a strong intuition: by sharing the instruments and policies underpinning economic prosperity, European nations would create an irreversible situation of interdependence and solidarity where conflicts and wars of the past would become impossible. This intuition led to the creation of the European Coal and Steel Community in 1951, then, a few years later, to the European Community. Thus in 1957 the signature of Treaty of Rome was the starting point of this unique experience of regional integration in modern History. This was more than a simple customs union since, from the beginning, external trade policy was a full Community competence. Even the CAP, whose image to day is not universally positive, was seen, at the time, as the archetype of a common policy, bringing together the shared interests and joint actions of member states.

The project was further developed and enriched in two directions. A further impetus was provided by the adoption of the Single European Act in 1986. This Act set a timeframe for launching the Single Market and reaffirmed the need for achieving Economic and Monetary Union (EMU). The Single Act created the framework for full economic integration, with total freedom in the flows of goods, services and capital between member states. Even today, in some service sectors, the EU is a more integrated area, from a legal and prudential viewpoint, than the United States. And second, the intrinsic solidarity between European nations was embedded into a policy of “cohesion” through which very important financial transfers took place, over a long period of time, between the richest and the poorest members. At some stage, some members have benefited for several years from such cohesion flows to an order of 5% of their GDP, significantly more than what most poor countries get from the IMF and the World Bank.

Many other developments – both on institutions and policies – took place over the years. And it is clear that, to day, the EU is much more than an economic project. But it is my strong opinion that the original intuition is still valid: it is by pooling and sharing the instruments of economic welfare and prosperity that European nations have reached and will develop a strong sense of their common destiny and a joint vision of their future.

Today, the EU has reached a diversified but, broadly speaking, very ambitious level of integration: it is complex because the degree of integration is largely dependent on which areas are at stake, it is ambitious since, in some areas precisely, the system is completely integrated and relies on one single policy.

The creation of the euro seems to me the natural consequence of the original intuition. It results both from a political vision and an economic and financial necessity. The process of monetary cooperation was launched as early as 1975, as a response to the potential financial and economic instability stemming from the collapse the Bretton Woods system. It met with many obstacles and went through several crises. At some point, it came close to being abandoned altogether. But today, the euro is alive and well: since 2002, it has been the sole currency with legal tender in all countries of the euro area, providing more than 300 million of European citizens with a new, practical unifying symbol as well as many direct economic benefits.

What are those benefits?

The first, and most obvious, is price stability. Over the last five years, inflation has stayed broadly in line with the price stability objective set by the European Central Bank, i.e. inflation below but close to 2% over the medium-term. Gone are the days when European citizens had to worry about the purchasing power of their savings. This stability goes beyond the behaviour of prices. Inflation expectations themselves have been remarkably stable, including during the recent period when oil prices jumped to levels no one could have expected only a year ago. This, by itself, illustrates the credibility achieved by the Eurosystem of Central Banks, after only six years of existence.

Second, European households and companies are reaping the benefits of that credibility. Long term interest rates stand at a historically low level, around 100 basis points below the level in the United States. So, even after the recent increases in short term rates, monetary and financial conditions remain extremely favourable for investment and growth. And indeed, we might be witnessing in Europe the start of period of sustained and stable growth, at least if current projections and surveys are proven to be right in the coming months.

A third benefit of the Euro is the boost it gives to financial integration in Europe. In many segments, European financial markets have reached the depth and liquidity which, up to now, were the preserve of dollar markets. This stimulates productive investment, helps in restructuring (as witnessed by the current wave of M&As) and, more generally, allows a better allocation of savings and sharing of risks.

As a consequence, the euro is becoming extremely attractive, as a vehicle, a transaction, an investment and a reserve currency. As you may know, as central bankers, we remain neutral as far as the internationalisation of the euro is concerned. We are neither encouraging, nor discouraging the process. But, as a citizen, I cannot help and feel proud of having one the two main currencies in the world.

Long term prospects

Looking into the future, I would like to try and answer four questions: is monetary integration sustainable in the long run? What are the prospects for the enlargement of the euro area? Can the euro serve as a model for other regions in the world? And finally, is monetary union going to lead to further political integration in Europe?

Solidity of the euro area

I am aware that there still is, on this side of the Atlantic, a lot of skepticism about the future for the euro. Four years ago, one of your leading academics, (Martin Feldstein) wrote a piece in Foreign Affairs arguing that monetary union would reignite conflicts and war in Europe.

This is, of course, the extreme form of a basic argument: that there are too many divergences between European states for them to withstand the pressures of monetary unification. Put in simple economic terms, it boils down to the argument that the euro is not an optimum currency area.

In my view, this is less and less true. While European labor markets are not – and will never be – as integrated as in the United States, goods, services, and capital markets are now fully unified, in many regards to a greater extent than in any other countries. Our studies show that business cycles tend to be more and more synchronized with time, an evolution which allows for greater efficiency and sustainability for a common monetary policy. This shows that monetary union is a self sustaining process: convergence can be a result, as much as a condition of economic integration. This has been termed the "endogeneity of optimum currency area" effects.

Enlargement of the euro area

As I said before, in contrast with some gloomy predictions made ten years ago, the euro is a success story. Far from being a closed Club, the Euro area is open and has a true calling for covering all the EU members, in so far as they fulfil the convergence criteria. Indeed, adopting the Euro can be seen as a legal obligation for all EU members once they have fulfilled the Maastricht convergence criteria. Monetary union is an on-going process.

Starting in 1999 with 11 members, the Euro area has regularly expended. On 1 January 2001, Greece joined the Euro area. More recently, on 1 January 2007, Slovenia was the first of the 10 New Members

States entered into the EU in 2004 to adopt the Euro; this brought the current number of members of the Euro area to 13.

At this stage, the relevant question for the new EU member states (NMS) is thus not whether but when to join the euro area. Entry is subordinated to the so called Maastricht criteria whose economic rationale is very strong. These criteria encompass: limited inflation differential vis-à-vis the best performing EU member; stability of the nominal exchange rate with the euro; sound fiscal accounts; and low long term interest rate spread vis-à-vis the best performing EU member states in terms of price stability. They must be satisfied simultaneously for the country to be able to join the EMU.

The economic rationale is clear: membership of a monetary union entails the absence of monetary policy as a domestic adjustment tool. Diverging inflation rates become quickly unsustainable both because they create strong real exchange rates movements and within the area and different real interest rates at the national level. In this context more inflation-prone countries would have too low real interest rates leading eventually to credit booms, domestic demand overheating, and loss in competitiveness and current account deficits. Furthermore, in the absence of an independent monetary policy at the national level, fiscal policy becomes the main adjustment tool. In this context, fiscal criteria were designed in order to assess the ability of the government to conduct sound fiscal policies.

Is the euro a model of monetary cooperation for other regions in the world?

What is happening in Europe is triggering a lot of interest in other parts of the world. Many countries to day, especially in Asia, are confronted with the same challenges we faced, in Europe, fifteen years ago: first, is it possible to reconcile greater economic integration with exchange rate volatility? And, if not, can fixed or pegged exchange rates regimes be sustained in an environment of full capital mobility? Taken together, these two questions led European countries to forgo monetary autonomy. Is this always advisable?

This is a very difficult question. My own answer would be to progress towards closer monetary cooperation with determination and caution. A strong degree of political determination is necessary because, clearly, full monetary autonomy becomes more and more problematic when economic integration has reached a certain stage. With greater economic openness, it is no longer an option, for small and medium size economies, to be indifferent to their exchange rates. On the other hand, independent management of their exchange rates by countries with close trade and investment links can lead to undesirable outcomes. Thus, cooperation is warranted.

Monetary union, however, is a demanding endeavor. I have alluded earlier to the theory of optimum currency areas. While it is debatable in some of its details and developments, the main message is clear: the exchange rate remains an essential adjustment tool whenever economies are faced with asymmetric shocks and markets are insufficiently flexible to absorb them internally. This is still the case in many regions of the world where regional economic integration moves at a rapid pace, but between countries whose economic structures and specialization are very different. In such circumstances, it would be extremely penalizing to give up the possibility of real exchange rate adjustments.

This shows that there is no single model of monetary cooperation which could be duplicated around the world. It is up to each group of countries to find their own sustainable path to economic integration.

Will monetary union evolve towards closer political union?

As you well know, these are difficult times for European political integration. The Treaty creating a Constitution for Europe was not ratified by two founding members of the European Community. As a consequence, the future of political integration is fraught with uncertainties. These raise several important questions for the future. Has the process of political integration stalled or just paused? What is the appropriate institutional framework for an enlarged Europe? These are questions best left for the historians and political scientists to answer.

But one question is essential: can monetary union progress and survive without a full fledged political union? Can we – to quote, Otmar Issing, my former colleague in the ECB's Executive Board – have "a currency without a state"? For me, like for Otmar Issing, the answer is clear: yes, we can. From the start, the European project has ventured into unchartered territory. We have created an institutional framework without any historical precedent and model. This is especially true for monetary policy, where we have transferred the decision making powers to a supra national entity. In that sense, monetary union in itself has a clear political dimension. This was only possible because euro area members had achieved a high degree of convergence in attitudes and preferences.

It also happens that, in all countries in the world, Central Banks have been made independent in the last decades, and monetary policy has been, as a consequence, depoliticised. This was seen as a necessity to ensure price stability. From that point of view, the euro is no exception and the ECB's mandate is similar to those of other Central Banks.

So, monetary union in Europe is well grounded, both on its technical and political pillars. Actually, the euro to day seems to me the main driver for European integration. It exists. It is a success. The institutional process is working smoothly. Sharing the same banknotes and currency has given European citizens a strong sense of common identity and joint destiny. And those who worried that monetary union would impede growth in Europe should be comforted by our recent record. Europe's growth rate to day is equal – or higher – to the US. In the six years since the creation of the euro, twice as many jobs have been created in Europe as compared to the US economy. Admittedly, we are lagging behind in terms of productivity growth, innovation capacity and market flexibility. But there is nothing which cannot be corrected provided the necessary policies are implemented with determination and continuity.

This is why, looking beyond the current difficulties, I feel very optimistic. And the reason for this optimism is the euro. The single currency has the potential to bring enormous benefits to European nations, which they can use to achieve a high degree of stability and prosperity, in the interest of all countries in the world.