Mr Duisenberg discusses the arrival of the euro

Speech by the President of the European Central Bank, Dr Willem F. Duisenberg, to the American European Community Association at the Netherlands Bank in Amsterdam on 14/1/99.

The euro has arrived! This was a very happy occasion. Although it has yet to appear in the tangible form of new banknotes and coins, there is no doubt that the new currency is set to play an important role, both in the euro area and beyond. After years of intensive preparation and successful economic convergence, a single monetary policy for the entire euro area determined by the Governing Council of the European Central Bank (ECB) is now being implemented by the Eurosystem, which is made up of the ECB and the eleven national central banks (NCBs) of the participating Member States.

The changeover weekend

The technical and logistical challenges posed by the changeover to the euro over the weekend of the New Year's Day public holiday have been successfully met. During the changeover weekend the Eurosystem monitored the conversion activities at the ECB, at the participating NCBs and at certain private institutions which – in the view of the Eurosystem – represent the core of the financial infrastructure in the euro area. Regular contacts were also maintained with other EU and non-EU central banks and the European Commission.

This monitoring activity during the changeover weekend was justified by the concern that, owing to the extraordinary concentration of operational risks within all the institutions of the banking and financial industry, events could occur immediately prior to the launch of Stage Three of EMU which might either impinge on the orderly conditions in the monetary system or create risks for financial stability at the very start of Monetary Union. The decision-making bodies of the ECB stood ready to gather for extraordinary meetings via teleconference, if necessary.

During the changeover weekend, no incidents that could have impaired the smooth start of Stage Three were reported to the Eurosystem. The successful navigation of the changeover weekend was the result of considerable and thorough preparation by a very large set of public and private institutions, including the ECB and the NCBs. Indeed, the introduction of the euro marks the culmination of a great deal of successful preparatory work over a period of many years. This has been reflected in the positive and confident way in which financial markets have received the euro in the first two weeks of Monetary Union.

Although some minor problems of a technical nature could not be avoided, overall the TARGET payments system has functioned well and contributed substantially to the integration of the euro money market. A number of "teething troubles" have been experienced as participants – in both commercial banks and central banks – adapt to the new system and environment. Nevertheless, during these early days of Monetary Union, TARGET has handled more cross-border payments than were anticipated, thereby demonstrating its processing capacity. With regard to monetary operations, on 4 January the Eurosystem announced its first main refinancing operation, which was successfully completed on the following day.

The role of monetary policy

A successful monetary policy must always be forward-looking, acting to contain threats to price stability before they become entrenched. Therefore, today I should also like to look to the future. Monetary Union is a unique and significant achievement. It promises a credible and lasting environment of price stability for almost 300 million people. This stable environment is the foundation for sustainable economic growth, better employment prospects and improvements in the standard of living throughout the euro area. Price stability is a necessary condition for improved economic performance in all these areas. I am confident that the single monetary policy will make the greatest possible contribution in this regard. The stability-oriented monetary policy strategy announced by the Governing Council last year, and which is now guiding monetary policy decisions, was designed with this goal in mind.

Nevertheless, monetary policy alone – however well designed and implemented – cannot solve Europe's economic problems. Appropriate fiscal policies and structural reforms implemented by national governments are vital and considerable progress is required in these areas. Moreover, continued wage moderation in both the public and private sectors would contribute to reducing the unacceptably high level of unemployment in many parts of the euro area.

Unemployment in the euro area is largely structural in origin. Implementing an inflationary monetary policy will not solve this problem, but rather exacerbate it over the medium term, as inflation distorts investment and saving decisions, raises the risk premium in long-term interest rates and undermines the allocative efficiency of the price mechanism. Only effective structural policies that improve the flexibility and efficiency of labour and goods markets can reduce unemployment in a successful and lasting manner. I appreciate that these structural reforms are not always easy to implement, not least because the benefits they yield occur mainly in the medium to long term. However, they are unavoidable. In those euro area countries that have taken up the challenge of structural reform, unemployment has fallen significantly. Other euro area countries should and must take note: structural reform throughout the euro area is fundamental to the success of Monetary Union and to improving Europe's economic performance.

The stability-oriented monetary policy strategy

The Treaty on European Union assigned the ESCB the primary objective of maintaining price stability in the euro area. You may rest assured that the Governing Council of the ECB is totally committed to fulfilling this mandate. In order to meet this commitment, the Governing Council has adopted a stability-oriented monetary policy strategy consisting of three main elements.

First, in order to give clear guidance in relation to expectations of future price developments, the Governing Council has announced a quantitative definition of its primary objective. Defining price stability also serves the principles of transparency and accountability. It clarifies how the Treaty's mandate is interpreted by the Governing Council and gives the public clear guidance concerning its assessment of the success of the single monetary policy.

Price stability has therefore been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Needless to say, deflation – that is, a persistent fall in the price level – would not be consistent with price stability. The annual rate of inflation in the most recent available data, measured on this harmonised basis, is consistent with the definition of price stability. The Eurosystem has therefore enjoyed the good fortune to assume monetary sovereignty in the euro area in an environment of price stability, owing to the successful process of disinflation and convergence achieved by national central banks during the last decade.

Price stability is to be maintained over the medium term. This reflects the need for monetary policy to be forward-looking and to have a medium-term orientation. It recognises the fact that monetary policy is not able to control all short-term movements in the price level.

To maintain price stability according to this published definition, the Governing Council's strategy relies on two pillars. First, a prominent role has been assigned to money, in recognition of the monetary origins of inflation over the longer term. This prominent role is reflected in the announcement of a quantitative reference value for the growth of a broad monetary aggregate, namely M3. The first reference value has been set at an annual rate of 4 ½%. The reference value for M3 is consistent with the maintenance of price stability over the medium term, while allowing for sustainable output growth and taking account of the trend decline in the velocity of circulation of M3.

Monetary policy will not react to deviations of monetary growth from the reference value in a "mechanistic" way. In the first instance, such deviations will be thoroughly analysed for the signals that they offer with regard to the prospects for price developments. If the deviation points to a threat to price stability, monetary policy will react in a manner appropriate to counter this threat, rather than attempting to eliminate the deviation of monetary growth from the reference value in the short term.

The second pillar of the monetary policy strategy is a broadly-based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole. The Governing Council of the ECB recognises that it is important, in parallel with the assessment of monetary growth in relation to the reference value, to look at a wide range of other economic and financial indicators, including economic forecasts. This systematic analysis of all other relevant information about economic and financial conditions will ensure that the Governing Council is as well informed as possible when taking monetary policy decisions.

Recent developments in monetary policy

A moment ago, I emphasised the importance of the formal introduction of the euro on New Year's Day. However, co-operation among European national central banks has been close for a long time and, among the NCBs of the countries participating in Stage Three, has become increasingly so in recent years and months. The co-ordinated interest rate cut at the beginning of December last year is an illustration of this co-operation. This co-ordinated interest rate move was thoroughly discussed by the members of the Governing Council of the ECB. De jure, the decision to change interest rates had to be taken by the national central banks but, de facto, Monetary Union existed in all but name prior to its formal implementation on 1 January 1999.

At its first December meeting, the Governing Council made a thorough assessment of the latest monetary data and other economic indicators, noting in particular the decline in business confidence in the euro area arising, in part, from the deteriorating external environment. This deterioration in the international economy has its origins, to a large extent, in the Asian and Russian financial crises. Following its appraisal of both pillars of the monetary policy strategy, the Governing Council concluded that key central bank interest rates of 3% would best serve the maintenance of price stability in the euro area over the medium term. National central banks adjusted their interest rates accordingly.

This co-ordinated interest rate move allowed the ECB to announce that the new level of interest rates would prevail “for the foreseeable future”. In other words, in the absence of further disturbances to the economy or the emergence of new and unanticipated threats to price stability, this level of interest rates should be appropriate to fulfil the primary objective of maintaining price stability over the medium term. This announcement helped to resolve some uncertainty at a time when the practical, technical and logistical tasks necessitated by the changeover weekend were uppermost in our minds and in those of market participants.

Following the second Governing Council meeting in December, I was therefore able to announce that the interest rate on the first main refinancing operation of the Eurosystem would also be 3%. Moreover, the interest rates for the deposit and marginal lending facilities – which, in normal circumstances, would constitute the upper and lower bounds for overnight market interest rates – were set at 2% and 4.5% respectively. As a transitional measure to help the financial system adjust to the new institutional environment resulting from the transition to Stage Three, from 4 January until 21 January a narrower band of 2.75% to 3.25% has been set for the rates on the deposit and marginal lending facilities.

During the first few days of Stage Three we observed a relatively large recourse by credit institutions to these facilities. This was to be expected, given the relatively narrow spread between the Eurosystem’s marginal lending facility and the overnight money market rate. Although the narrow corridor is intended to facilitate the transition by market participants to the new regime, over a longer period of time such a measure would hamper the development of an efficiently functioning euro area money market. We therefore intend to terminate the transitional measure of the narrow band next week, in line with our pre-announced schedule.

Assessment of the current economic situation

At the meeting of the Governing Council of the ECB on 7 January it was confirmed that the 3% rate would apply to the Eurosystem’s next two main refinancing operations. This level is based on the Governing Council’s current assessment of the economic situation, viewed from the perspective of the stability-oriented monetary policy strategy.

First, monetary growth in recent months has been broadly in line with the quantitative reference value. This, together with further analysis of the monetary data, signals that monetary developments are consistent with the maintenance of price stability over the medium term. Of course, monetary growth relative to the reference value should always be interpreted in a medium-term context. Short-run deviations from the reference value are inevitable and, while being monitored and assessed carefully, would not automatically signal an immediate threat to price stability. Nevertheless, it is reassuring that the three-month moving average of the annual growth rates of M3 up to November 1998 stood at 4.7%, very close to the reference value of 4½%.

Second, as regards the broadly-based assessment of the outlook for price developments, a number of indicators have recently proved noteworthy. Following the co-ordinated interest rate cut at the beginning of December, long-term interest rates have also fallen, suggesting that financial markets viewed the cut favourably and considered it to be consistent with the credible maintenance of price stability over the medium term. The indicators emerging from the real economy are mixed. Overall, real GDP growth in the euro area weakened in the third quarter of last year as compared with the first half. While business confidence, orders and capacity utilisation have developed less favourably in recent months, the latest data for employment, retail sales and consumer confidence suggest more favourable trends.

Against this background, the annual rate of increase in the HICP for the euro area slowed further in November, falling to 0.9% as compared with 1.0% in the previous two months. This reduction in the rate of increase of the HICP resulted from further moderation of food price increases and continued falls in energy prices. On balance, the general environment continued to suggest that there is no significant upward or downward pressure on the price level.

Of course, the Governing Council is fully aware that potential risks to price stability do exist. On the one hand, the external environment could again deteriorate if the financial crises in Asia and Russia were to spread or deepen further. On the other, fiscal indiscipline by national governments failing to respect the Stability and Growth Pact or inflationary wage settlements could threaten the 2% upper bound of the Eurosystem's published definition of price stability. The Governing Council is monitoring all these developments very closely and will react in a prompt and pre-emptive manner to ensure that neither inflationary nor deflationary pressures take hold.

The international role of the euro and the ECB

Changes in the external environment – that is, in the economic condition and performance of countries outside the euro area – may affect the outlook for price developments within the euro area, and thereby the conduct of the single monetary policy. The effects of financial crises on external demand and business confidence are a notable recent example. However, this relationship works in both directions. The introduction of the euro has created a single currency area of a size and importance and with a population broadly similar to the United States. An event of this magnitude is likely to have major implications for the rest of the world, especially the international financial system. In the remainder of my speech, I shall consider some of these implications.

In its monetary policy strategy, the Eurosystem deliberately does not specify a target for the exchange rate of the euro against the US dollar or the Japanese yen. Although it will always stand ready to exchange views with other central banks concerning the development of exchange rates, there are no explicit or implicit target zones for the euro exchange rate against non-EU currencies. The euro area is a large, relatively closed economy, similar in this respect to the United States. Pursuing a target for the euro exchange rate could easily jeopardise the maintenance of price stability. The level of interest rates required to sustain an exchange rate target may, in some cases, not be that which best serves the maintenance of price stability over the medium term. I might add that it may also conflict with the achievement of other domestic policy objectives. It could be very painful if it were necessary to raise interest rates in a recession in order to defend the exchange rate of the euro. Finally, it should be acknowledged that today we are living in a world with high capital mobility. Exchange rate arrangements that could be implemented thirty years ago may no longer be feasible. The required amount of foreign exchange reserves could simply be too large.

Within the Eurosystem's monetary policy strategy, the euro exchange rate is the outcome of current and expected economic policies and developments in both the euro area and elsewhere, and of the market participants' perception of these policies and developments. Supporting the Eurosystem's approach, the Ministers of Finance, who are assigned ultimate responsibility for the exchange rate of the euro by the Maastricht Treaty, have agreed not to issue so-called "general orientations" for the exchange rate policy to the Eurosystem other than in clearly exceptional circumstances, such as when there is a substantial and persistent misalignment of the euro against other currencies.

However, the absence of a target for the exchange rate of the euro against major international currencies does not imply that the ECB ignores or is indifferent to the exchange rate of the euro vis-à-vis the US dollar or the Japanese yen. The exchange rate will be monitored as one of the indicators of monetary policy, within the broadly-based assessment of the outlook for price developments that constitutes one pillar of the overall strategy. Nor does the absence of exchange rate targets suggest that these rates will necessarily be unstable or volatile. On the contrary, the pursuit of stability-oriented monetary and fiscal policies puts in place one of the major prerequisites for stable euro exchange rates. The Eurosystem's stability-oriented monetary policy strategy is a significant contribution in this regard. Absolute stability of the exchange rate is, of course, impossible to guarantee. It would not even be desirable if, for example, the United States and the euro area were to go through business cycles that were not fully synchronised. This possibility cannot be ruled out, as even recent history has shown.

We are aware that the emergence of an international role for the euro may sometimes complicate the conduct of monetary policy if a significant proportion of the money stock is circulating outside the euro area. Nevertheless, the Eurosystem will accept the international role of the euro as it develops as a result of market forces. To the extent that the Eurosystem is successful in meeting its mandate and maintaining price stability, it will also automatically foster the use of the euro as an international currency. The pace at which the euro will emerge as an international currency is hard to predict. If history is taken as a guide, it will be a gradual process, but it is possible that, in today's more dynamic and flexible financial markets, the euro could assume a prominent role more rapidly than past experience might suggest.

Finally, I should like to discuss briefly the role of the ECB in international co-operation. As the representative of a monetary union comparable in size and importance to the United States and as the central bank managing a currency that is likely to play a large and increasing international role, the ECB will inevitably play an important role in the international financial system. The ECB will embrace the implied responsibility, but at the same time it will have to be modest and realistic in its actions on the international stage. Its role will develop over time, drawing on the experience of those national central banks that have played an important international role in the past.

At the end of last year, the ECB was accorded observer status at the International Monetary Fund (IMF). Full membership of the IMF is restricted to individual nations. Nevertheless, this observer status will allow the ECB to participate fully in the relevant work and assessment by the Fund of economic policies in the euro area and beyond. The ECB also participates in the work of the G-7, the G-10, the Bank for International Settlements and the OECD. It enjoys good bilateral relations with other central banks throughout the world.

The ECB stands ready to participate fully in, and contribute to, international policy discussions. It will, of course, offer expertise and exchange views, when and where appropriate. However, in general, the best contribution the ECB can make to a stable international monetary system, including stable exchange rates and well-functioning international capital markets, is to maintain price stability within the euro area. Fulfilling the mandate assigned to the ESCB by the Treaty on European Union will help the ECB to meet its international responsibilities.

Concluding remarks

The euro has arrived. The Governing Council of the ECB has taken up the reins of monetary sovereignty in the euro area and a truly single monetary policy has been in place for two weeks. For those of us who have been involved in the long and at times arduous preparations for

Monetary Union, this is an occasion which provides a sense of satisfaction. However, as I have outlined in this speech, in many ways the real work of the ECB is only just beginning. The stability-oriented monetary policy strategy is in place. I am confident that this framework will enable the Governing Council to fulfil the Treaty mandate of maintaining price stability. Meeting this mandate will ensure that the single monetary policy makes its best possible contribution to improving the standard of living in the euro area and helping to ensure the stability of the international financial system.

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