Mr Noyer discusses implications of the introduction of the euro and some basic structural features of EMU

Speech delivered by Mr Christian Noyer, Vice-President of the European Central Bank, at the European Institute in New York on 29 September 1999.

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Ladies and Gentlemen,

It is a pleasure for me to be able to address you today and to share with you some remarks about the changes which Economic and Monetary Union (EMU) in Europe has brought about. In so doing, I should like to focus my comments on the introduction of the euro and the immediate implications for European and international financial capital markets, for central banking and the European economy as a whole. However, the launch of a new currency, historic as it was, does not constitute a one-off event. In fact, it is the longer-term dynamics of EMU which represent the great challenge for the years to come. In the second part of my address I should therefore like to touch upon some basic structural features of EMU – which have perplexed observers within the EU, but especially outside Europe – namely, how a single monetary policy can indeed function in the absence of a unified political entity.

Before that, allow me to briefly explain our terminology, with which you may, as yet, be unfamiliar. The "Eurosystem" is the name given to the European Central Bank (ECB) and the – at present – 11 national central banks of those countries which have introduced the euro. The "euro area" is the term used to refer to these 11 countries. The "European System of Central Banks" also includes the central banks of the four EU Member States which have not, as yet, adopted the euro.

The launch of the euro

On 1 January 1999 the European Union achieved a new and unprecedented stage of economic integration. With the launch of the euro, 11 countries merged their monetary sovereignty and transferred the task of conducting a common monetary policy to a supranational institution, the Eurosystem.

This historic step was the culmination of a long period of preparation, the magnitude of which can hardly be overestimated. EU Member States embarked upon an ambitious and sometimes painful fiscal consolidation process; exchange rate crises and hostile public opinion in some countries had to be overcome by a clear political conviction that the project would eventually succeed. At the technical level, the banking and financial sectors, EU legislators and many others diligently prepared the changeover to the new currency in cooperation with the ECB itself, its precursor organisation – the European Monetary Institute – and the national central banks.

Indeed, the thorough preparation has paid off: the euro got off to a smooth start. Given the sheer scale and significance of the project, it is, of course, unsurprising that it did not proceed entirely without hitches; on the whole, however, there were no major complications. External developments such as the initial depreciation of the euro against the dollar have attracted somewhat pessimistic headlines; but there are, in fact, several reasons for some satisfaction. The Eurosystem, and specifically the Governing Council as its main decision-making body, has taken up its responsibilities of formulating and implementing the single monetary policy. In so doing, the Governing Council – which comprises the 11 national central bank governors of the euro area countries and the six members of the Executive Board of the ECB – has not only shown its determination to think and act for the euro area as a whole but has also proven its capacity for decisive action – as exemplified by the decision to cut the ECB's main refinancing rate to 2.5% in April.

With the launch of the single currency, the Eurosystem successfully began to operate a system of centralised setting and decentralised implementation of monetary policy, using a new set of rules and procedures. In line with its Treaty mandate, the Eurosystem has also assumed its wider tasks and responsibilities, relating, inter alia, to the collection of statistics, the preparations for the issuance of banknotes or the operation of payment systems.

The impact of the euro on financial markets

The introduction of the euro has brought about momentous change in the financial markets, not only within the euro area, but also on a global scale.

- First, a functioning *money market* for the euro area as a whole is a precondition for the successful operation of the Eurosystem's single monetary policy. In order to allow this euro area money market to operate smoothly, the Eurosystem has established the requisite cross-border transfer and payment systems. The progress achieved in overcoming the previous fragmentation is highlighted by the rapid increase in transaction volumes within money markets and the almost immediate normalisation of bid-ask spreads. Even at this early stage there is every justification for observing that the euro money market has already achieved considerable depth and a high degree of liquidity.
- Second, the advent of the new currency has also brought about a transformation of the European *capital markets*. Even though capital movements within the European Union had already been liberalised by the early 1990s, the prospect of a truly pan-European capital market was still remote. It was the advent of the euro which provided a decisive impetus towards the further development of a single euro area capital market. This market is set to become even deeper and more liquid over time, and hence more efficient.
- One particular area of the capital market in which the markets in euro area countries have traditionally been considerably less active than in the United States is the *corporate bond and commercial paper market*. The evidence of the last few months suggests that the issuance of euro-denominated bonds has indeed exceeded dollar-denominated issues. These data indicate not only the high level of confidence in the new currency, but also point towards the gradual establishment of a deep and liquid bond market in the euro area in the foreseeable future. Such a development should have a favourable impact on business activity and might stimulate further consolidation by way of mergers and acquisitions.
- Third, the introduction of the euro also appears to lend new urgency to greater integration and efficiency in *equity markets*. As consolidation within the financial service and banking sectors has increased the size and geographical reach of intermediaries and fund management institutions, they seem to be pressing for market-places to become more concentrated in order both to reduce costs and to enhance liquidity. These developments might eventually also lead to a closer coordination of trading practices and technology among stock exchanges, and the planned link-up of eight exchanges in Europe appears to point in this direction. Yet at the same time, the use of advanced information technology renders the physical location of stock exchanges less relevant. A developing perception of the euro area as an entity in itself is also reflected in the emergence of area-wide equity indices which provide investors with opportunities to monitor area-wide equity positions as well as, in some instances, positions in area-wide industrial sectors.

To sum up, the introduction of the euro has led to a perceptible shift in euro area (and EU) financial markets; greater depth, liquidity and integration should improve their efficiency, and a more efficient allocation of capital should mean improved financing opportunities for both sovereign and corporate borrowers.

Having set out the immediate impact of monetary unification on financial markets, I should like to give you a brief overview of the institution at the heart of managing our new currency, namely the Eurosystem.

The role of the Eurosystem

Since 1 January 1999, the Eurosystem has had exclusive competence for monetary policy in the euro area. In fulfilment of this task, the Treaty establishing the European Community assigns to the Eurosystem the primary task of maintaining price stability. In order to guide expectations of future price developments and to facilitate the public's assessment of the success of the single monetary policy, the Governing Council has announced a quantitative definition of its primary objective: price stability has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%, to be maintained over the medium term.

The Treaty also states that the European System of Central Banks shall support the general economic policies in the European Community, as long as it can do so without prejudice to the objective of price stability. The very wording of the Treaty reveals its logic, namely that the best contribution which monetary policy can make to high employment and economic growth is to maintain price stability.

In its very essence, Economic and Monetary Union is of course a European endeavour. However, even at this stage it is clear that the introduction of the euro has implications for the global economy. Figures relating to the official and private use of the new currency reveal that the Eurosystem will have responsibility for an international currency of considerable standing. However, allow me to stress in this context that the Eurosystem does not pursue a policy of actively encouraging or discouraging the international use of the euro.

As has probably become clear from my remarks so far, we can derive considerable satisfaction from observing how well the immediate challenges of the introduction of the euro have been mastered, both by the financial markets and monetary policymakers. Allow me in the second part of my address to concentrate on some of the longer-term challenges which the project of monetary unification will face.

One single monetary policy for 11 different economies

Looking at EMU from an external perspective, one might be tempted to ask: "It has worked so far, but will it last?" Is it sustainable for the Eurosystem to conduct a single monetary policy while economic policies continue to be shaped by 11 different governments?

The blueprint for economic and monetary union as set out in the Maastricht Treaty does indeed envisage the establishment of a single monetary policy to be conducted by a new supranational institution, the Eurosystem, with the ECB at its centre. Economic policies, on the other hand, have essentially remained the competence of the Member States. At the time, many commentators doubted the feasibility of a monetary union in Europe without some form of "political union".

Today, nine months into the life of the new currency, our first experiences allow us to paint the following picture. From the very outset, monetary union in Europe has been conceived as a complement to the Single Market, a logic neatly summarised in the title of the Delors Report study: "One market, one money". Europe's Single Market already represents a remarkable degree of economic integration. A plethora of common rules govern economic life in the 15 Member States and create, to a large extent at least, a unified market serving 375 million people. The realisation of the free movement of goods, services, capital and people has integrated national economies and rendered national borders increasingly obsolete. A common competition policy has created a level playing-field, and common norms and standards guarantee Europe-wide market access.

Certainly, Europe's Single Market is yet to be fully completed: a number of sectors have yet to be fully liberalised and brought into the remit of common rules. Nevertheless, the notion of a unified "European economy" has acquired real substance, not least in the wake of the prominent "1992 Programme".

But is the degree of economic integration achieved so far with the Single Market sufficient for the proper functioning of a monetary union on a lasting basis? From the Eurosystem's point of view, the Europe-wide economic "governance" is of particular importance in a number of policy areas.

First, the completion of the Single Market in the area of financial services is paramount to the functioning of Monetary Union. In fact, euro area financial markets began the process of integration even before the introduction of the euro, and a large amount of work is currently under way to further develop a prudent, harmonised regulatory framework and to harmonise market practices. Harmonisation of, for example, repurchase agreements, national company laws (including bankruptcy laws) and other aspects of the legal and regulatory framework are set to enhance legal clarity and certainty and thereby improve the efficiency and stability of the financial markets.

Beyond the realm of financial markets, a functioning Economic and Monetary Union will require an increased awareness on the part of all Member States of the spillover effect of their national policies, especially their budgetary policies. Without this, the Eurosystem's single monetary policy would face severe pressures. In order to anchor responsible fiscal policies in the EMU rule book, the Treaty itself contains stipulations which oblige Member States to treat national economic policies "as a matter of common concern" and subject them to a multilateral surveillance procedure. These rules derive additional force from the existence of sanctions in the event of persistent excessive deficits. The stipulations have been further refined and made more effective by the Stability and Growth Pact agreed in 1997.

Our first experiences with these EU-level economic policy instruments show that the consolidation of public finances has indeed become a priority for all Member States, and that efforts, although not always sufficiently ambitious, have been undertaken to achieve balanced budgets in the medium term. Given Member States' high overall debt burden, the Eurosystem continues to call for heightened efforts to this end, especially in times of cyclical upturn such as the one we are experiencing at the current juncture. But even so, striving towards sound public finances, combined with the Eurosystem's stability-oriented monetary policy, should help to create favourable macroeconomic conditions such as Europe has not enjoyed in the past.

However, the euro area economies will only achieve higher growth rates and cut their chronically high unemployment rates in the long run if the necessary structural reforms are enacted. Not least due to the constraints imposed by the single currency, there now appears to be a growing recognition among policymakers in Europe that over-regulation of labour markets, perverse incentives created by some elements of the welfare systems and rigidities throughout the economy urgently need to be addressed. In so doing, Member States are increasingly willing to learn from each other, to accept "peer pressure" and study examples of "best practice".

That said, it would be ill-advised to overrate the need for coordination, for example, with regard to social security or direct taxation systems: a healthy competition between national economic policies in such fields can certainly produce superior results. The process of economic convergence in the euro area, despite great progress over the past years, is not yet complete and will not be so for the foreseeable future. Under these circumstances, Member States must retain sufficient room for manœuvre to allow for differentiated policy responses.

In any case, developing an awareness of the euro area dimension of domestic economic policy decisions will be a gradual process. In this context, there should be no illusions: adapting to the new conditions of the single currency – where monetary policy is exogenously set by the Eurosystem – will demand a steep learning curve from policymakers, businesses, trade unions and the public at large.

Conclusion

I should like to conclude by remarking that the establishment of Economic and Monetary Union marks an outstanding historical achievement, a new quality in the process of Europe's integration. While we can certainly look back on the first few months of this endeavour with considerable satisfaction, we are aware that the task of making EMU a success will be an ongoing one. But, as my remarks have revealed, there is every reason for optimism: the euro's success is built on sound foundations. Further improvements are, of course, necessary, but we are confident that they will be accomplished. Clearly, the Eurosystem's stability-oriented monetary policy is a principal ingredient of a successful EMU, in which the euro enjoys both the trust of citizens as well as the confidence of investors.