Mr Noyer focuses on the challenges in Europe as seen from the point of view of the European Central Bank

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the University of Antwerp on 26 October 1999.

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Introduction

First of all, I should like to thank the organisers of the Kekulé Cyclus for inviting me to participate in such an interdisciplinary conference bringing together experts from different professional backgrounds. I will contribute to your discussions by focusing on the challenges we are facing in Europe, as seen from the point of view of the European Central Bank (ECB).

Let me briefly recall that it was just a little over a year ago that the ECB was established and that for almost ten months now the Eurosystem – which consists of the ECB and the eleven national central banks of the Member States which have adopted the euro – has been responsible for monetary policy in the euro area. The introduction of the euro has been a historic event for the countries concerned, since it is the first time in monetary history that sovereign states have replaced their national currencies with a common currency and transferred their monetary policy competencies to a newly established supranational institution.

The new monetary policy regime in the European Union (EU) is not only an important further step in European integration. It will also have far-reaching implications for the world economy and the international monetary system. In this context, the ECB, together with other policymakers in Europe, has a particular responsibility in setting the right conditions for sustainable non-inflationary growth in the euro area so as to contribute to long-term economic welfare of the world economy.

Thus, in my presentation today, I should like to concentrate on three aspects related to the challenges we are facing in Europe today and in the future and, in that context, on the contribution of the ECB and the Eurosystem: first, I shall reflect on how we can seize the opportunity to ensure that the current economic recovery in the euro area becomes a prolonged phase of sustainable non-inflationary growth and employment creation. Second, turning to Europe as a whole, I shall refer to the challenges related to the accession of new countries to the EU and, eventually, to the euro area. Finally, broadening the perspective, I will discuss the role of Europe, the euro and the ECB in the world economy.

1. Challenges in the euro area: how can the ECB and the Eurosystem contribute to sustainable non-inflationary growth and employment creation?

Starting with the euro area, recent economic developments point to a much brighter outlook than was expected earlier this year. An improved international environment should support these positive prospects. As shown by the IMF’s recent World Economic Outlook, the growth prospects in individual countries and for the global economy in 1999 and 2000 are now much better and more balanced than expected.

While the risk of a pronounced slowdown of the US economy, with negative repercussions on the world economy, cannot be ruled out, such a scenario appears unlikely at present. However, a major challenge for the US authorities over the next few months is engineering a “soft landing” of the US economy. The Japanese economy now shows clearer signs that the protracted weakness of the last few years could come to an end. An economic consolidation and a resumption of capital flows to crisis-hit emerging market economies, especially in Asia, also contribute to this favourable outlook.

Against this positive background, the challenge now is to ensure that the current recovery in the euro area becomes a period of prolonged non-inflationary and employment-generating growth. I will elaborate on the possible contribution of the ECB and the Eurosystem, but also on the limitations thereof, pointing to the necessary contributions of other policymakers.

Looking back at the past ten months, I would like to recall that the introduction of the euro took place in an environment of price stability that only few observers would have predicted some years ago. This was the result of a process of economic convergence, in the course of which European inflation rates were reduced significantly.

This development is very encouraging, since theoretical arguments and empirical evidence over several decades suggest that high and variable rates of inflation are detrimental to growth and employment in the long term. Against this background, the predominant view has emerged that the best and most lasting contribution that monetary policy can make to long-term economic welfare is that of safeguarding price stability. Therefore, central banks throughout the world have been moving towards adopting long-term price stability as their primary goal.

In order to achieve this goal most successfully, independence from political interference and a clear legal mandate for price stability are of the utmost importance. A lack of independence and an ambiguous mandate can easily force central banks to focus on the short term, and thus to fail to adopt the forward-looking, medium-term orientation that is crucial for a successful monetary strategy. These aspects were taken into consideration by policymakers when drafting the Maastricht Treaty.

The mandate to maintain price stability cannot be seen in isolation. The Treaty assigns other tasks to the Eurosystem. Article 105 requires that the Eurosystem "without prejudice to the objective of price stability … shall support the general economic policies in the Community, with a view to contributing to the achievement of the objectives of the Community." These Community objectives include "sustainable and non-inflationary growth" and "a high level of employment". But, given the qualification "without prejudice", the Treaty also clearly states how the Eurosystem shall set its priorities. A contribution to the achievement of the other objectives of the European Community can only be made if the Eurosystem's primary objective is not compromised. However, there is ultimately no incompatibility between maintaining price stability and pursuing these other objectives at Community level. It is by maintaining price stability that the ECB will contribute to the achievement of growth and employment creation.

Of course, this contribution is a necessary, but not the sole pre-condition. A central bank can set monetary conditions in a way that helps the economy to grow at its potential. Even if this condition is met, monetary policy is not enough to reduce significantly the high level of unemployment in Europe. This high level of unemployment reflects mainly *structural rigidities* within the European labour and product markets. This is confirmed by the fact that the European unemployment rate has remained high and broadly stable over business cycles in the past decade. Only comprehensive structural reform can therefore remove the underlying impediments to higher employment. In particular, further reforms of the tax and welfare systems are required in many EU countries in order to increase the incentives to create new jobs and to accept them. Wage moderation can also have a significant beneficial impact.

National governments bear the main responsibility for structural reform designed to enhance market flexibility. I recognise that these reforms may imply difficult political decisions, especially since necessary changes are felt directly, whereas the benefits only become apparent over time. The success, however, of past structural reforms is already visible in those countries where appropriate measures have been implemented and wage growth has been moderate.

Another argument supporting better functioning labour and product markets is that the monetary policy of the Eurosystem is and can only be geared to the euro area as a whole. It can thus not take into account *purely national or regional developments*. The cyclical positions of participating countries have not yet completely converged, although – with the single currency in place – some national differences may disappear over time. This requires national policies and labour and good markets to be increasingly flexible in order to be able to respond effectively to economic shocks that can affect any monetary union. A single currency does not call for uniform wage developments or for uniform economic and social policies in general. On the contrary, where national or regional economic and productivity developments are different, this should be reflected in different policy responses and wage developments.

Budgetary policies, too, are crucial for setting the necessary conditions conducive to growth and employment creation. Sound public finances, with lower public debt and tax burdens, contribute to a reduction of long-term interest rates, reduce uncertainty and increase private capital formation. Thus, they not only facilitate the task of monetary policy to maintain price stability, but also strengthen the conditions for sustainable growth conducive to employment creation. Conversely, unsound fiscal policies tend to increase inflation expectations and force monetary policy to keep short-term interest rates higher than would otherwise be necessary. Therefore, the Stability and Growth Pact, which encourages the pursuit of disciplined and sustainable fiscal policies by Member States' governments, is a crucial element for sustainable non-inflationary growth in the euro area. The consolidation of public finances, which has made considerable progress in the past few years, has to be continued and, in some cases, intensified.

Setting the monetary conditions required to maintain price stability in the euro area is certainly the best contribution that the Eurosystem and monetary policy can make. To achieve this aim, the Eurosystem has adopted a *monetary policy strategy* which is tailored to the unique conditions of introducing a new currency. Our two-pillar strategy takes into account that economic behaviour may change as a result of the introduction of the euro itself. The first pillar lends a prominent role to money, as signalled by the announcement of a reference value for the growth rate of the broad monetary aggregate M3, which is regarded as being compatible with price stability; within the second pillar, the outlook for price developments is assessed on a broad basis, using a variety of financial and economic indicators.

This strategy thus takes into account that the start of EMU constitutes a structural break. A better knowledge of the structure and functioning of the euro area economy, and of the transmission mechanism of monetary policy within it, will be gained over time. Similarly, the availability and quality of economic statistics will improve. As experience is gained, our strategy will be reviewed and may evolve, possibly in the direction of greater emphasis on one of the two pillars. However, this has to be a prudent process, since one of the main functions of a strategy is to provide a tool to facilitate the communication of monetary policy preparations and decisions. Continuity is therefore a major feature of any monetary policy strategy.

The effectiveness of a monetary policy strategy and related decisions depend to a large degree on the credibility of the institution. Transparent and accountable policymaking can help to build up a reputation and, hence, credibility. Openness, transparency and predictability therefore rank high on the agenda of the ECB and the Eurosystem. Monthly press conferences given by the ECB's President and myself are an important part of our communication policy. They take place immediately after the first Governing Council meeting each month, thus providing an opportunity to explain our decisions and the basis on which we have taken them, and to answer questions from journalists. As far as I know, no other central bank communicates with the public in such a prompt manner.

Communication is and should not be a one-way street. The ECB must also take note of and be sensitive to its environment in order to be effective in its own polices. But, still, monetary policy has to be conducted independently of short-term political considerations. In this context, the ECB cannot commit itself to move its interest rates in a certain way in response to specific actions or plans of other policymakers. Monetary policy has to take the overall economic situation into account in its assessment of the risks to price stability. For a monetary union to be viable, the fact that monetary conditions may not be tailored to the specific needs of each individual component of the euro area has to be accepted.

Explaining this properly to eleven countries with different economic, political and cultural backgrounds is also one of the challenges we are facing. It will probably be better understood over time, subject to further progress being made towards a positive attitude regarding European integration. Such a positive attitude – that is seeing Europe as a positive opportunity – will also help to cope with the challenges posed by the accession of new countries to the EU. This leads me to the second part of my presentation.

2. Looking ahead – the accession of new countries to the EU and, eventually, the euro area

European integration as well as monetary union is an ongoing process and will continue to be so in the future. Four EU countries have, for different reasons, not yet adopted the euro. Without elaborating on that, let me simply state that they may well join in the coming years.

A greater challenge is the potential accession of still more countries to the European Union and, ultimately, the euro area. Negotiations are currently being conducted with six countries. Negotiations with another six candidates may start soon. The eligibility criteria for their accession to the EU were formulated by the European Heads of States and Government at their summit in Copenhagen in 1993. These criteria set out what should be required of a future Member State of the European Union and thus ensure equal treatment of all applicant states. Let me briefly recall the three criteria that have to be fulfilled:

- first, the political criterion requires stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;
- second, the economic criterion requires the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the EU; and
- third, the so-called "acquis communautaire" criterion requires the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

While accession is a political decision, it is clear that extending the EU to include new members will have consequences for the ECB and the Eurosystem. Following their accession to the EU, the new Member States will also – in a second step – become members of the exchange rate system ERM II and – in a third step, if and when the Maastricht convergence criteria are met – adopt the euro.

In view of the implications for its own tasks and objectives and of the advisory role it can play, it is only natural that the Eurosystem will become more involved in this process.

The Eurosystem should be involved in all issues falling within its exclusive or shared areas of competence: monetary policy, exchange rate policy, foreign reserve management, payment systems, financial stability and the impact of enlargement on the Eurosystem itself.

The Eurosystem is currently in the process of defining its position. Let me briefly outline some preliminary observations. The Eurosystem needs to have a positive attitude towards the prospects for an enlargement of the EU. This also applies to subsequent participation in ERM II and the eventual adoption of the euro. The Eurosystem should be prepared to advise these countries in pursuing appropriate structural reforms and stability-oriented policies in line with accession and convergence criteria. The Eurosystem should stand ready to provide technical assistance to accession countries, in particular to their central banks.

Equal treatment should be a key feature of the accession process. Objective and uniform criteria should apply both to the countries' accession and to their participation in ERM II and adoption of the euro. These criteria, related to each step of the process, should be implemented in a strict and effective manner, in order to provide the countries concerned with the external constraints necessary to bring their economies into line with the respective standards and the final goal of EMU, while also avoiding any discrimination.

Against the background of different starting points and possibly different lead-times for progress towards real and nominal convergence, a plurality of approaches should be feasible without compromising equality of treatment. This may apply, in particular, to the timing of the individual steps towards accession.

In accordance with the Treaty establishing the European Community, the Eurosystem will always focus on the maintenance of price stability in the euro area. Hence, our involvement in the accession process, including our technical assistance, and any arrangement or other forms of cooperation with accession countries, must be without prejudice to the Eurosystem's independence and its primary objective.

Over time, the Eurosystem – like other EU institutions – will face the necessity of institutional adjustments required by enlargement. These adjustments should preserve the efficient functioning of the Eurosystem and its ability to maintain price stability in an enlarged euro area. In the case of previous enlargements, the entry of new Member States often brought about so-called "arithmetical adjustments" to the composition of EU institutions. However, an enlargement by as many as 12 new countries may require more substantial adjustments. This is one of the reasons why a new Intergovernmental Conference on enlargement-related issues will be convened by the end of this year. In this regard, as provided for in the Treaty on European Union, the Eurosystem would stand ready to take part in any initiative taken by the competent EU institutions on issues falling within its competence. Such institutional adjustments should be without prejudice to the fundamental features of the Statute of the ESCB, namely the Eurosystem's mandate and its independence.

The Eurosystem is closely monitoring developments in accession countries, which are directly related to its own areas of competence. Of course, this is done in cooperation with the countries concerned. A network of contacts has been established with the relevant central banks, and several bilateral and multilateral meetings have been convened in recent months. This process will be intensified over the coming months and years, with a view to deepening cooperation in areas of mutual interest. In this regard, I should like to mention the high-level meeting with the central banks of the accession countries to be held in Helsinki next month.

Let me now turn to the role of the euro, the ECB and the Eurosystem in the world economy.

3. The role of the euro, the ECB and the Eurosystem in the world economy

The introduction of the euro certainly represents one of the most profound changes in the international monetary system since the collapse of the Bretton Woods system in the early 1970s. The euro is the currency of an economic area with a population of nearly 300 million people and one-sixth of world GDP, which is significantly higher than that of Japan, although smaller than that of the United States. The euro area is the largest trade partner in the world economy with a share of 20.1% in world exports, followed by the United States with a share of 16.3% and Japan with a share of 7.6%. Given these facts, it is stating the obvious to say that the euro and the Eurosystem are likely to play an important role in the world economy.

By reducing the number of key players in the international arena and by strengthening the awareness of each player to take up its respective responsibility, the euro will contribute – over time – to facilitating international cooperation. But the transfer of competence for monetary policy from the national to the Community level also implied that new arrangements had to be found in order to allow the Eurosystem to participate and represent the euro area in matters of its competence.

Devising the appropriate arrangements was complicated because of two specific features: the first relates to the fact that membership in different fora (for example, the G7 or the G10) varies across euro area Member States. The second derives from the fact that full membership in intergovernmental institutions such as the International Monetary Fund (IMF) or the Organisation for Economic Cooperation and Development (OECD) is restricted to countries only. Therefore, in all of these instances, specific arrangements had to be devised in order to provide for the representation of the Eurosystem and the ECB. We have now reached formal and informal agreements with the IMF, the OECD and the Bank for International Settlements (BIS) as well as in the G7 and G10 context. Let me briefly comment on two of these arrangements:

- In December last year, the ECB was granted permanent observer status in the *IMF*. This was a particularly important step. The IMF, as the cornerstone of the international monetary system, plays a key role in the process of multilateral surveillance of economic policies. The ECB Observer attends all meetings of the IMF Executive Board that are of relevance to the Eurosystem, such as discussions on multilateral surveillance or the Fund's surveillance of euro area monetary and exchange rate policies. As far as the Interim Committee of the IMF is concerned, which has recently been given the new name of the "International Monetary and Financial Committee", the President of the ECB participates in its meetings as an observer.

- Regarding meetings of the *G7 Finance Ministers and Central Bank Governors*, it was agreed that the President of the ECB will be the sole representative of the Eurosystem in discussions on multilateral surveillance and exchange rate issues. This part of the G7 meetings will also be attended by the Presidency of the Euro-11 Group.

These arrangements will enable the Eurosystem and the ECB to participate fully in international cooperation. This is all the more important since the international agenda contains important items for the future. The generally improved outlook for the world economy should not lead to complacency and to a diminishing of the reform efforts initiated in the aftermath of the financial crises of the past two years. Strengthening the architecture of the international financial system remains an important topic on the international agenda. The financial crises in Asia, Russia and Brazil, with risks of contagion to other emerging market economies and spill-over effects into capital markets of matured economies (e.g. LTCM in the United States), highlighted the need substantially to improve the ability to prevent and resolve crises. Against this background, a wide range of proposals was put forward and reviewed. One important aspect concerns the strengthening of the soundness of the banking systems and of regulatory and supervisory frameworks in emerging market economies. Another reform initiative relates to the transparency of the private and public sectors. The main objective here is to improve available information through the elaboration of international standards and codes of good practices. Further progress in that area will contribute significantly to crisis prevention, since improved information will enable a better risk assessment by market participants.

The challenge now is to keep the political momentum for reform and to pursue the implementation of the envisaged measures in order to strengthen the resilience of the international financial system. The Eurosystem is actively participating in these ongoing discussions. Our focus in these discussions is clearly on crisis prevention. If, however, another financial crisis was to occur in the future, it should be handled in a way that will not create incentives for both creditor countries and investors which are incompatible with the future stability of the international financial system.

Again, the best contribution the Eurosystem can provide to international stability is to maintain price stability in the euro area. International policy cooperation which goes beyond the exchange of information and views on issues of mutual interest could easily become counterproductive, compromising both the Eurosystem's mandate and international financial stability itself.

With the creation of the euro, there has been a renewed interest in the concept of *target zones for exchange rates* among the main currency areas, namely the Unites States, the euro area and Japan. But, in a world characterised by highly integrated and sophisticated international financial markets, there is serious doubt as to whether target zones for exchange rates are feasible or even desirable. Such exchange rate targets would imply that domestic policy objectives would have to be subordinated to external requirements. This would – in certain circumstances – conflict with the primary objective of price stability and result in a greater volatility of business cycles, as the burden of adjustment would be transferred to domestic policies and developments.

But the fact that the Eurosystem does not have an exchange rate target does not imply that we are indifferent to exchange rate developments or that we will neglect them. The exchange rate of the euro is monitored within the second pillar of our monetary strategy as a potentially important indicator for monetary policy. If its development poses a threat to price stability in the euro area, the causes of this development will be assessed and appropriate measures taken.

With regard to the use of the *euro as an international currency*, the Eurosystem has adopted a neutral stance: we will neither hinder nor actively promote the international role of the euro, but leave its development to market forces. We observe that the euro is already second only to the US dollar as the most widely used currency in the world, ahead of the Japanese yen. In general, the international use of a currency is determined by several factors. Private agents may use a currency for international trade and investment, as well as for pricing and denomination purposes. In the official sector, it is used as an anchor for exchange rate pegs, for holding foreign exchange reserves and for the conduct of foreign exchange intervention.

The successful changeover to Stage Three of Economic and Monetary Union (EMU) played an important role in promoting the role of the euro. During the so-called changeover weekend, the bulk of bonds, shares and other financial instruments were re-denominated in euro. The same applies to outstanding government debt. Thus, since the start of EMU, investors have been able without any difficulty to borrow and lend funds in euro, and to trade their euro securities on the secondary market. Looking ahead, it is likely that over time international investors will start to hold a greater proportion of their portfolios in euro-denominated assets than they held in the former national currencies. In other words, the role of the euro as an international currency is likely to be greater than that of the sum of its components. One reason why this may be the case is that the economy and the financial markets backing the euro are large relative to the world economy. In this regard, one of the key elements influencing the international use of the euro is the creation of a large, liquid and integrated capital market in the euro area.

As for trade, the existence of a large capital market will also encourage and facilitate the use of the euro in international transactions. In particular, many euro area exporters and importers, who did not previously use their own domestic currency for invoicing, may now take the opportunity to do so with the euro. The same tendency could gain ground in those countries that have close economic ties with the euro area or which have chosen to peg their currencies to the euro.

This brings me to some considerations on the use of the euro in the official sector. Apart from the EU countries participating in ERM II, a number of countries – mainly in Central and Eastern Europe and in Africa – have unilaterally decided to peg their currencies either to the euro or to one of its legacy currencies. Other countries are pursuing managed-float policies, with the euro as the main reference currency, whereas another group of countries is pegging their currencies to baskets of currencies, such as the Special Drawing Rights containing the euro. Against this background, the use of the euro is likely to increase both as an intervention currency and as a reserve currency. As a matter of fact, just like private international investors, central banks may find it convenient to diversify their portfolios to incorporate a currency offering broader investment opportunities than its legacy currencies.

Apart from the existence of a large, liquid and integrated capital market, another major prerequisite for the substantial use of a currency by foreign investors is confidence in the long-run stability of its purchasing power. In this regard, internal price stability should provide a sound basis for the development of the euro’s external value in the medium term. By maintaining price stability, the Eurosystem is contributing to the emergence of a solid and stable currency over the medium term, thereby fostering the euro’s international role.

Conclusions

Coming to the end of my speech, let me quote Mark Twain by saying that predictions should be avoided, particularly those about the future. However, there is little doubt that Europe’s agenda for the immediate and longer-term future will be full of challenging tasks. I have outlined the three areas in which Europe will have actively to shape its future: the euro area, the enlargement of the EU and its role at the international level. The fact that these areas are interlinked and that progress will have to be achieved simultaneously adds to the challenges we are facing. From a more general point of view, Europe should aim at becoming a stronger partner in international cooperation and, as far as possible, at speaking with one voice. Such an ideal cannot be realised overnight, but every effort possible should be made to move in this direction. A stronger, more integrated and coherent Europe is in the interests of the world at large. In order to be able to play this role on the international scene, Europe should keep an eye on the rest of the world and, in spite of the many challenges it will face internally in the years and even decades ahead, it should avoid adopting an exclusively inward-looking stance.