Mr Noyer briefly outlines the historic evolution of EMU and summarises the experience gained with the euro

Speech delivered by Mr Christian Noyer, Vice-President of the European Central Bank, at the London School of Economics and Political Science on 6 December 1999.

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Ladies and Gentlemen,

It is a pleasure and an honour for me to speak here at the London School of Economics and Political Science today. Since the introduction of the euro, this distinguished university has attracted numerous speakers from the European Central Bank (ECB). In my remarks I should like to briefly outline the historic evolution of Economic and Monetary Union (EMU) and to summarise the experience gained with the euro in this first year. By subsequently addressing forthcoming challenges, I should then like to span the bridge towards the future.

The single currency offers a great opportunity to achieve the objective of sustained and widespread price stability in Europe. For the euro to become a "success story" as the single currency for around 300 million people, the confidence of the population in the stability of the new currency and in the Eurosystem, i.e. the ECB and the national central banks (NCBs) of the 11 participating Member States of the European Union (EU), plays a crucial role. The Eurosystem has already made a great deal of progress in building up its credibility and gaining a sound reputation in financial markets for its monetary policy in its short history.

The establishment of a "stability culture" throughout the euro area will contribute to the stability of the euro. The foundations of this stability culture are to be found in a broad consensus among Europeans that the maintenance of price stability is of utmost importance. A stability culture also facilitates the achievement of other objectives, such as high employment.

Let me emphasise that the establishment of Monetary Union marks an outstanding historical achievement. With the introduction of the euro, integration in Europe has gained a new quality both from an economic and from a political perspective.

Launching the euro - historic evolution

The "short past of the euro" was preceded by a long period of preparation and discussion about closer monetary integration. Let me briefly recall the major milestones in this process. First steps towards the introduction of a single European currency were taken almost 30 years ago when the six initial Member States of the European Economic Community proposed a plan for the creation of an economic and monetary union. This culminated in the so-called Werner report which was named after the former Prime Minister of Luxembourg who chaired the group in charge of the study.

Following the collapse of the Bretton-Woods system of quasi-fixed exchange rates, with the US dollar as a "gold-convertible" anchor currency, most countries in Europe switched to flexible exchange rates. For many observers, this world-wide retreat from fixed exchange rate systems came close to an early knock-out for the idea of monetary union in Europe. However, in reaction, the European Economic Community adopted a new resolution which established a fluctuation band of 2.25% within which the currencies of Member States were permitted to float. This so-called "snake in the tunnel" lasted only a few years. It demonstrated the difficulties in maintaining fixed exchange rates in Europe among countries with diverging inflation rates and a lack of co-ordinated economic policies.

European monetary integration received a fresh impetus with the establishment of the European Monetary System (EMS) 20 years ago. The EMS was designed as a symmetric system of fixed but adjustable rates. It allowed member currencies to float within bands of 2.25% above and below bilaterally fixed central exchange rates. Symmetric intervention obligations aimed at stabilising the exchange rates of members within the bands were part of this exchange rate mechanism. In cases of misalignments, the possibility of realigning parities was foreseen.

In June 1988, under the chairmanship of Jacques Delors, a former President of the European Commission, a report regarding the introduction of a single currency was initiated. This report concluded with the recommendation to achieve Economic and Monetary Union in a three-stage process. The first stage already started on 1 July 1990 and focused mainly on the increased co-ordination of economic and monetary policies between the Member States. With a view to increasing the integration of financial and capital markets during this stage, existing barriers were gradually removed. In November 1993 the Maastricht Treaty was ratified, thereby creating the legal foundations for a supranational monetary union in Europe.

In 1994, only 5 years ago, the second stage of EMU began. At that time the European Monetary Institute (EMI) was created as the precursor to the European Central Bank. Its task was to carry out preparatory work and to contribute to the realisation of the conditions necessary for the transition to the third stage of EMU. In that phase, Member States increased their efforts to conduct disciplined economic and monetary policies so as to fulfil the necessary conditions for the adoption of a single currency, in particular the so-called convergence criteria which concerned inflation rates, budget deficits, government debt ratios, exchange rates and interest rates. Member States were expected to make further efforts so as to ensure a smooth transition to Stage Three. For example, they had to amend national laws so as to make them compatible with the Treaty and to make their NCBs fully independent before the start of Stage Three. In 1995, three new Member States - Austria, Finland and Sweden - joined the European Union.

Finally, on 1 January 1999, the European Union reached a new and unprecedented stage of economic integration. With the launch of the euro, 11 countries gave up their monetary sovereignty and transferred the task of conducting the single monetary policy to a supranational institution. This historic step marked the culmination of a long period of successful preparatory work, the magnitude of which can hardly be overestimated. As a result of these efforts, the introduction of the euro took place in an environment of price stability that only a few observers would have predicted some years ago.

The start of Monetary Union proved to be a formidable undertaking. In spite of huge operational challenges, the changeover took place without any incidents affecting the orderly functioning of the monetary system, not least as a result of the successful preparatory work of the EMI and, since mid-1998, the Eurosystem.

The introduction of the euro had important implications for the international capital markets. This was due to the fact that a number of the currencies replaced by the euro had played an important international role in the past. It also holds true because the euro has become the currency of an economic area which roughly equals the United States in terms of economic size and external trade, and which has the world's second largest capital market.

First experience gained with the euro

Let me describe the first experience gained with the euro from the ECB's point of view. The Eurosystem's monetary policy strategy provides financial markets and the public with an important framework on the basis of which monetary policy decisions can be explained in a consistent and predictable manner. In our view, the monetary policy strategy has passed its first tests successfully.

At the core of the strategy is a clear primary objective for price stability. A clear definition for the overriding objective of maintaining price stability in the euro area contributes to stabilising market expectations. The Eurosystem defines price stability as a year-on-year increase of below 2% in the Harmonised Index of Consumer Prices (HICP) for the euro area. The Eurosystem aims to maintain price stability in line with this definition over the medium term.

Let me briefly outline how the Eurosystem's monetary policy strategy helps the ECB Governing Council to fulfil its task of maintaining price stability in the euro area. The first pillar of that monetary policy strategy assigns a prominent role to money. There is a broad consensus that inflation is actually a monetary phenomenon in the medium term. Therefore, monetary developments provide an important benchmark for any monetary policy that is aimed at safeguarding price stability. To emphasise the prominent role assigned to money, the Governing Council of the ECB announced a quantitative reference value for monetary growth in terms of the broad definition of M3 in October 1998. The first reference value was set at a rate of 4½% per annum. At its last meeting, the Governing Council reviewed this reference value and concluded that the assumptions underlying its derivation remain valid. Thus, there was no reason to change the reference value of 4½% M3 growth per annum. The Governing Council has decided henceforth to review the reference value on a regular annual basis, with the next review to take place in December 2000.

I should like to emphasise in this connection that the reference value is not an annual target. First, it is based on medium-term assumptions and serves as a guide for developments over the medium term. Second, the ECB is not committed to ensure that M3 grows in line with the reference value at a particular point in time.

The ECB does not focus solely on money. The problem with looking only at money is that, in the short run, the relationship between money and prices can be distorted by portfolio shifts and institutional factors. Short-term developments in money therefore need to be analysed very carefully. Against this background, the Governing Council of the ECB has always communicated to the public that it cannot and will not react mechanically to deviations of actual monetary growth from the reference value. In this sense, the concept underlying the Eurosystem's strategy is different from monetary targeting in the traditional sense. Monetary policy should always react to all the information available with a view to maintaining price stability in the medium term. For this reason, the Eurosystem's strategy is based on two pillars.

The second pillar of the monetary policy strategy is a broadly based assessment of the outlook for price developments in the euro area as a whole. This assessment encompasses a wide range of indicator variables, including macroeconomic projections produced both within and outside the Eurosystem.

Within the stability-oriented monetary policy strategy, the exchange rate is an important variable for the Eurosystem as it is one of the determinants of the outlook for price stability. If exchange rate developments pose a threat to price stability in the euro area, this threat will be taken into account together with the information on price developments revealed by all other indicators.

The chosen strategy is forward-looking in nature and oriented to the medium term. It is sufficiently flexible to allow for appropriate responses to specific shocks. The monetary policy strategy eschews mechanistic reactions to any single indicator, including monetary aggregates or inflation forecasts.

There have been some suggestions that the ECB should abandon its two-pillar strategy over time. I clearly do not share this view. I am convinced that our strategy has worked very well and will continue to be appropriate for the euro area. There is broad consensus that the uncertainties surrounding the start of Stage Three were unprecedented in European history and continue to require special attention. The Eurosystem has a framework which truly reflects the complexity of the economy. It also allows account to be taken of the possibility of a regime shift at the start of Stage Three which could impact on the stability of important economic relationships. It would be impossible for the Eurosystem to conduct a successful monetary policy by mechanistically following a simple rule whereby policy decisions are closely linked to a single indicator.

The ECB has committed itself to be open, transparent and accountable. For this reason, the ECB provides the general public with detailed background information on its monetary policy and the Governing Council's interest rate decisions. For example, immediately after the first Governing Council meeting each month, the introductory statement of the President is released. This practice is similar to the publication of minutes, and has the advantage of presenting the Council's assessment of the economic situation almost instantaneously after the meeting. Each month the ECB publishes a bulletin providing additional background information to explain its current assessment of monetary, financial and other economic developments in more detail. Once a year, the ECB releases an annual report on its activities to the European Community institutions.

As mentioned earlier, the Governing Council regularly carries out an independent assessment of the monetary, economic and financial conditions prevailing in the euro area as a whole. These deliberations of the Governing Council provide the basis for monetary policy decision-making at the euro area level. Let me now very briefly recall the most important factors influencing the interest rate decisions taken by the Eurosystem in the course of 1999.

In the first few months of this year, there were increasing indications that the negative effects of the crises in Asia and Russia on growth and employment in the euro area might be more serious than had initially been expected. With the apparent cyclical slowdown in economic growth in the euro area, the balance of risks to future price stability moved significantly to the downside. This assessment was also reflected in the downward revisions to the inflation forecasts of international organisations. At that point in time, growth was slightly above the reference value, but there were several indications - also against the background of historically low interest rates - that M3 was temporarily being distorted upwards in early 1999 as a result of the changeover to Stage Three of EMU. Thus, in early 1999, it did not appear that M3 growth revealed upside risks to price stability, in particular as non-monetary indicators pointed to increased downside risks for future price developments. All in all, the forward-looking and medium-term orientation of the single monetary policy made it necessary for the Governing Council to take action. With a view to maintaining price stability in the euro area over the medium term, the Governing Council of the ECB thus decided at the beginning of April 1999 to reduce the interest rates on the main refinancing operations by 50 basis points to 2.5%.

At around the beginning of the summer, it appeared that prospects for economic growth in the euro area had improved. During the summer months both pillars of the Eurosystem’s strategy concurred in indicating that the balance of risks to future price stability had gradually been moving towards the upside. Monetary growth had increased considerably in the course of 1999. The three-month average stood at 5.9% for the period from July to September 1999. Even when the data was adjusted for the somewhat specific movements of M3 in January and February, we could see that the annualised figure for M3 growth from March to September was 6.1%. All this took place in a significantly different economic environment than in April. For this reason, the Governing Council had to react. On 4 November the Governing Council decided to raise the interest rates on the main refinancing operations by 50 basis points to 3.0%.

The increase in interest rates at that point in time was aimed at helping to counter the upward pressure on future prices and at contributing to keeping inflation expectations safely below 2%. The interest rate decision was thus taken in a forward-looking manner which focused on maintaining price stability and would thus contribute to sustaining non-inflationary economic growth in the euro area over the medium term.

I think that this comparison between the two decisions to change ECB interest rates in April and November is instructive. It shows that we do not react mechanistically to individual indicators, but always interpret the movements and signals in all of the indicators evident in both pillars in conjunction with each other. As we can see, this is a more reasonable approach than relying on a simple indicator, given that we are living in a complex world.

After having discussed our strategy and the rationale behind our monetary policy decisions against the background of that strategy, I should like to say a few words about the Eurosystem’s monetary policy instruments. The single monetary policy of the Eurosystem is based on an operational framework that is common for all euro area countries. This operational framework turned out to be an effective instrument for steering money market interest rates and for limiting fluctuations in overnight rates. The Eurosystem influences money market conditions mainly through its regular open market operations. The weekly main refinancing operations provide the banking system with short-term liquidity and the interest rate on this instrument gives an indication of the Eurosystem’s monetary policy stance. In addition, the “standing facilities” effectively limit fluctuations in the money market interest rate. Finally, the averaging provisions of the minimum reserve system have contributed towards smoothing daily fluctuations in the money market.

The success of this operational framework can be demonstrated by the fact that the Eurosystem has not yet found it necessary to recourse to any fine-tuning operations. Moreover, since January, active market participants have typically and quickly eliminated cross-country interest rate differentials in the money market through arbitrage. Overall, developments in short-term money market interest rates have thus far been very stable and money market rates have, on average, been close to the interest rates at which the ECB has provided liquidity through its weekly main refinancing operations.

For an efficient conduct of monetary policy operations, it is essential to have the support of a powerful payment system. Since its establishment, TARGET has become one of the largest real-time gross settlement payment systems in the world. The system has increased the use of real-time gross settlement in the EU by roughly 20% since the introduction of the euro. According to available data for September, the system now processes approximately 3.5 million domestic and cross-border payments, which have a total value of about EUR 20 trillion, per month. Moreover, cross-border payments represent 40% of the value of all TARGET payments.

The long future of the euro

Let me now try to look ahead towards the "long future of the euro" and the challenges which the ECB and the Eurosystem will have to address. The experience with the short past of the euro justifies expectations that we will gradually see further advances towards a broadening of economic and monetary integration in the future. With the establishment of the Eurosystem, solid foundations for a stable currency were laid. Maintaining price stability in the euro area helps to gain credibility and the confidence of European citizens in the stability of the euro. This will also contribute to the increased use of the euro outside the euro area.

Expectations of a long future for the euro seem warranted in light of the increasing confidence of European citizens and international investors in the single currency. The international interest in the euro is indeed evident, for example, from international new bond issues. According to information from the Bank for International Settlements, the volume of new issues in euro almost doubled in gross terms in the first half of 1999, compared with the same period last year.

An important challenge for both monetary policy and economic policies is to maintain non-inflationary growth in the euro area. In the forthcoming years - I am confident - we will see that the current recovery has extended to become a period of price stability contributing to prolonged employment and output growth. However, there are important conditions to be met to achieve a substantial and sustained increase in output growth and lower unemployment. First of all, decisive measures to address the structural problems in Europe, in particular in the area of labour markets, are needed. Second, the consolidation of public finances, which has made considerable progress in the past few years, has to be continued and, where necessary, strengthened.

Sound fiscal policies make monetary policy's task of maintaining price stability easier. In this context, the Stability and Growth Pact is a crucial element. Its aim is to encourage the pursuit of disciplined and sustainable fiscal policies by both the participating EU Member States and prospective members. In so doing, it can contribute significantly to the establishment of favourable conditions for sustained economic growth and high employment in the medium term.

In the coming years, the success of EMU demands that the clear distribution of responsibilities between the Eurosystem and government authorities, as set out in the Maastricht Treaty, is followed. This clear separation of responsibilities is efficient, transparent and conducive to accountability. It takes account of the substantial empirical evidence and practical experience of the fact that monetary policy makes its best possible contribution to the achievement of other goals by focusing on the primary objective of maintaining price stability over the medium term, thereby enhancing the credibility of both monetary and economic policies in Europe.

The high degree of implicit co-ordination between economic policies and the single monetary policy which can be achieved if policy-makers each focus individually on their overriding objectives supports the view that the Eurosystem should not engage in ex ante policy co-ordination which could be falsely interpreted as negotiations with other policy-makers on its monetary policy stance. By agreeing to condition monetary policy actions to certain fiscal and structural policies or wage developments, such co-ordination might hinder the Eurosystem's prompt response to threats to price stability arising from other sources. If market expectations were to reflect a belief that the effectiveness and success of the single monetary policy would be constrained by any kind of co-ordination, this could threaten the maintenance of price stability.

In the course of the next decade, we will also see the accession of a number of new Member States to the European Union and possibly to the euro area. It is clear that the envisaged extension of the EU to include new members and, ultimately, the enlargement of the euro area represent important challenges both for Member States and for the Eurosystem. Any enlargement of the euro area is subject to political decisions, and not automatic. I should like to recall that the Maastricht Treaty provides for a clear and transparent procedure, which lays down the conditions for EU Member States wishing to join the euro area. The basic prerequisite is that the convergence criteria must be complied with. This should ensure that Member States provide evidence of sufficient economic convergence with the euro area before adopting the euro.

The introduction of the euro in other countries will require not only compliance with the convergence criteria, but also further preparatory work in various areas. For example, new members have to ensure that the harmonised framework in which the single monetary policy operates is fully in place prior to their participation in the euro area. Statistics need further adaptation so as to comply with the Eurosystem’s reporting requirements. Some changes in national legislation are needed to formally lay the foundations for the introduction of the euro. Finally, all procedures that involve the Eurosystem and the prospective member country will have to pass a number of real-time tests in order to demonstrate that the infrastructure is operational.

Conclusions

In summary, the first year of operation of the ECB has been successful and the monetary policy strategy of the ECB has proved to be a valuable tool both in supporting monetary policy decisions and in explaining these decisions to the general public in a transparent manner. As to the time ahead, the ECB will do its utmost to maintain price stability in the euro area. In our view, this is the best contribution the ECB can make to sustained economic growth in the euro area. Maintaining price stability in the euro area will contribute to the credibility of the single monetary policy and to the stability of the single currency. It will pave the way for the long future of the euro.