

Speech by M. Jean-Claude TRICHET

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"The conditions for the euro to be a success"

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Ladies and gentlemen, it is a great pleasure and an honour for me to be speaking here in London on the outlook for Economic and Monetary Union. So I would like to thank you for giving me the opportunity to express my views on EMU in front of such a distinguished audience.

One month ago, a unique event in the history of Europe occurred. The euro was born and the irreversible nature of this change has convinced an increasing part of the political and economic actors that the success of the euro is a necessity for Europe and the rest of the world. It is a keystone of the European single market which will ensure prosperity in Europe. But, now and for the future, we have to face a number of challenges to make this success sustainable.

Central banks are at the heart of the changeover to the euro, both at the European level and in their national economies. This is why I would like today draw your attention particularly to the following three issues :

- First, Economic and Monetary Union is based on deep and solid conceptual and economic foundations that allowed a successful launch of the euro on the financial markets, one month ago;

- Second, the euro area will have to face up to a number of challenges if it is to stay an area of monetary stability and where growth is sustainable;
- Third, the success of the euro will make a major contribution towards encouraging a more balanced international monetary situation.

I/ EMU IS BASED ON DEEP AND SOLID FOUNDATIONS THAT ALLOWED A SUCCESSFUL LAUNCH OF THE EURO ON THE FINANCIAL MARKETS ONE MONTH AGO

On the 31st of December 1998, the Heads of State and Government adopted the irrevocable conversion rates for the euro against the currencies of the eleven countries that were chosen for participating in the euro area. This historic step marked the achievement of Economic and Monetary Union. The impressive progress towards economic convergence during the last few years leading up to the decision contributed decisively to this process. And, with a view to guiding the financial markets, the method for determining the irrevocable conversion rates for the euro was agreed in Brussels, on the 3rd of May.

All in all, underlying the creation of the euro is a well-founded idea; moreover, it reflects the crowning of a long economic and political process. Deep preparatory work has also contributed to the successful launch of the euro on the financial markets.

A. EMU is based on deep and solid foundations

1. The creation of a monetary union and a single currency is not a recent, abstract concept born from the imagination of a few people. The Maastricht Treaty is the outcome of a series of important initiatives that already belong to the history of Europe. The Werner report, produced at the beginning of the 70's, set up the concept of Economic and Monetary Union. The *Maastricht Treaty* was negotiated, signed and ratified by the twelve first, and then by the fifteen member countries of the European Union. I would note that thirteen countries approved it without any restrictions.

2. The rationale for EMU lies in the economic advantages a single currency will bring to Europe as a whole.

The European Union (including non euro area countries) brings together 370 millions citizens, represents almost 20% of the world GDP and accounts for around 21% of world trade (intra-european trade excluded), compared with around 17% for the United States and 10% for Japan. The advantages inherent in the sheer size of the Single Market are obvious. It enables the whole productive sector to make significant economies of scale and allows savings to be allocated to the most profitable investments. It also enhances market visibility and boosts competition to the benefit of consumers.

From this point of view, the single currency is the *crowning achievement of the single market*. The ultimate objective of the single market cannot be achieved while monetary barriers continue to prevent the free flow of goods, services and capital by imposing transaction costs and the inherent exchange risks. Tomorrow, our citizens will enjoy all the facilities related to using the same monetary instrument throughout the European continent, just like Americans do today throughout the territory of the United States.

The *advantages of the single currency* are numerous.

The single currency will reduce uncertainty and facilitate investment and production decisions. It will

allow prices to be compared fairly throughout Europe and will reduce transaction costs. The single currency area will be marked by price stability and low inflation. This in turn will preserve and strengthen confidence and give the European economy a favourable financial environment.

The very fact of the single currency will allow more capital to be raised at better conditions on broader, deeper and more liquid markets.

3. The creation of the euro crowns the EMU process in the best way, since it is based on the strict fulfilment of convergence criteria and on price stability. This is resulting in the convergence of Member States towards the best economic performance.

According to a French saying, one should not build on sand. This is why the Maastricht Treaty set up convergence criteria, which countries must durably abide by to join monetary union.

In this context, I would like to underscore France's performance. France is one of the three countries that have complied rigorously with the reference values of all the Maastricht criteria, including the outstanding debt-to-GDP ratio. Our price stability and low long-term interest rates have placed us among the best-performing three countries : in accordance with the

Treaty, our results thus constituted, with two other economies, a benchmark for assessing the results of all. The Banque de France has contributed -directly and indirectly - to these results, by implementing an independent and credible monetary policy.

In this regard, I would like to stress a very important point. In building a monetary union, the European countries are not only merging their economic, commercial, financial and monetary aggregates, making the euro area a major partner in terms of population (290 millions of citizens), size of GDP, or of international trade, or of monetary aggregates. We have embarked in building a solid and stable area. This means that the monetary union is not a mere arithmetical aggregation of national economic performances. It is based upon benchmarking against the best performers in terms of monetary stability. The Monetary Union area is therefore made up of countries whose monetary and financial performances have converged towards those of the most stable and credible currencies.

The objective of the monetary authorities in the euro zone is monetary stability. The Maastricht Treaty has given to the newly-created European System of Central Banks (ESCB) a clear mandate to maintain price stability. The ESCB is fully independent of the national and European authorities in the pursuit of this objective.

In other words, national central banks are independent and their statutes are compatible with the Treaty. The ESCB has inherited the credibility of the national central banks in charge of the most reputable currencies, in Germany and France.

On October 13th and on 1 December 1998, the ECB presented the monetary policy strategy that will be pursued in stage three of Monetary Union. This strategy ensures continuity with the monetary policies of the participating national central banks:

- Price stability has been defined as a year-on-year increase in the HIPC for the euro area of below 2%. Price stability is to be maintained over the medium term. Defining price stability also serves to establish the principle of transparency and accountability.
- a prominent role has been given to money. This role is signalled by the announcement of a quantitative reference value for the growth of a broad monetary aggregate, namely M3. The reference value for 1999 has been set at an annual rate of 4 1/2%. It should be noted that the concept of a reference value doesn't imply a commitment on the part of the ESCB mechanistically to correct deviations of monetary growth from the reference value in the short term. But, the reference value for M3 is consistent with

and will serve to achieve the maintenance of price stability over the medium term.

- . the other pillar of the monetary policy strategy is a broadly based assessment of the outlook for future price developments in the euro area as a whole. It is thus important to monitor a wide range of economic and financial variables as indicators for future price developments.

The coordinated interest rate move to a level of 3%, in December, allowed the ECB to announce that the new level of interest rates would prevail "for the foreseeable future".

The single monetary policy alone cannot ensure price stability without the appropriate fiscal discipline at the overall level of the Economic and Monetary Union.

For my part, I would give *three economic justifications* for the Treaty provisions that gave rise to the Stability and Growth Pact.

First, by coordinating the fiscal policies of the Member States of Monetary Union, the pact ensures a good *policy mix* within the euro area. This is essential for monetary policy. Since Europe does not have a significant federal budget, just as it has no federal government, the sum of the national budgets must

serve as an overall budget for the area as a whole. This calls for close mutual surveillance and coordination of fiscal policies within the area.

Second, the pact helps prevent well-run economies from having to bear unjustified risk premia by setting up a system of *penalties* for excessive deficits.

Third, the stability pact allows us to disprove the assertion that the euro area has no automatic stabilizers in the event of asymmetric shocks to a member economy. Indeed, by urging governments to aim for a fiscal position of close to balance or in surplus in the medium term, the pact enables them to let fiscal deficits increase during recessions without exceeding the 3% reference value. In short, it allows them to create a fiscal buffer during normal economic periods that can be drawn on if an asymmetric shock occurs.

B. Deep technical preparatory work has allowed a successful launch of the euro on the markets

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During the so called "changeover weekend", the ESCB monitored the conduct of conversion activities at the

ECB, within the participating national central banks and in certain core infrastructural areas. Information has been exchanged on a regular basis through a network of communication points between the ECB and the NCBs. No incidents were reported that were thought likely to impair the smooth start of the system. So, it started normally on the 4th of January, at the opening of the markets.

These results are a sign of the quality of the preparatory work conducted over recent months and years by the central banking community and by private financial market operators. As regards the **French banking and financial community**, the end of last year was dedicated to the planning and testing phases in order to organize the switchover of capital markets during the *last week-end of 1998*. These preparations allowed a very successful conversion process.

2. This preparatory work has allowed a successful launch of the euro on the financial markets

On 4th January, the euro was successfully launched. From that day onwards, the Eurosystem (ie the ECB and the eleven national central banks of the euro area) has assumed responsibility for the conduct of monetary policy in the euro area with the primary objective of maintaining price stability.

We can express satisfaction with the changeover to one integrated euro area money market that emerged immediately in the initial days.

With respect to the broadly based outlook for price developments, at the meeting of the Governing Council of the ECB on the 7th of January, financial market developments were seen as indicating a favourable assessment of the monetary policy decisions of the Eurosystem, signalling that financial market participants expect the environment of price stability to continue.

In order to facilitate the integration of national capital markets, an agreement has been reached on the computation and publication of an interest-rate index for interbank transactions ; this index, called Euribor, replaces former national indices and covers the maturity range from 1 month to 12 months. Euribor has rapidly become the main short term benchmark for the operations in euro. The launch of an overnight interest-rate index, known as Eonia has already proved its importance since it gives a precise representation of money market conditions all over the euro area; it is a very useful reference for market operators and economic agents, as well as for the ECB, which use it as reference for a large majority of contracts and transactions.

III/ THE SUCCESS OF THE EURO WILL BE COMPLETE IF A CERTAIN NUMBER OF CHALLENGES ARE TAKEN UP

The introduction of the euro is in itself a major structural reform. But it will only succeed if some conditions, regarding structural reforms in particular, are met and if the euro is embodied in the behaviour of political and business leaders and also entrepreneurs, consumers and, above all, our fellow citizens.

A. To ensure the success of the euro, European countries have to meet four conditions

A few years ago, it was necessary to convince a great number of sceptic people, in Europe and all over the world, that the euro was a viable project. Many people pointed to its presumed contradictions, and its alleged inconsistencies: for example, the impossibility of achieving an efficient policy mix without a political federation; the impossibility of avoiding some "asymmetric shocks" (that is to say difficulties occurring in a Member economy and not in others); the lack of sufficient flexibility and real mobility of the labour force in the European countries etc...The conclusion was that the euro would never exist! Facts have refuted these

criticisms. But they are useful to help answer the question of what are the conditions for ensuring that the euro is a complete success. I see four conditions:

-The first condition is the credibility of monetary policy guaranteed by the independence of the European Central Bank, which is enshrined in the Maastricht Treaty and rooted in the independence of each national central bank. If the euro is to be a credible currency, it must win the confidence of both the 290 million Europeans in the euro area and non-Europeans with whom we do business. This can only be ensured by resisting any kind of pressure, including political, on how the new currency is managed. Satisfying this first condition will be facilitated, by the harmonious functionning of the European monetary team, which is composed of the ECB and the national central banks from the eleven founder countries.

-The second condition is compliance with the provisions of the Treaty and the guidelines laid down in the Stability and Growth Pact with regard to fiscal policy. Close coordination of fiscal policies and vigilant peer surveillance within the informal council of the eleven participating member states - the "Euro Eleven Club"- and by the ministers of finance of the 15 Member States convened in the Ecofin Council is essential to ensure a balanced policy mix throughout

the eurozone. Adherence to the medium-term objective of achieving " public finances that are close to balance or in surplus" -meaning nobody gets to run a selfish budget deficit - is indispensable for the union as a whole to weather periods of economic difficulty and for individual countries to withstand possible economic downturns which affect only them.

It was the commitment by all European Governments to the Stability and Growth Pact that made possible the recent decision by the ECB and national central banks to lower interest rates to 3% -a cut that surely supports growth.

-The third condition is that all European countries must resolutely undertake structural reforms. Continental Europe is experiencing high levels of unemployment, despite the fact that the jobless rate has been declining slightly in most of its economies. According to the IMF and the OECD, around 80% of this unemployment is structural, that is, generated by our own burdensome rules and regulations. The Monetary Policy Council of the Banque de France agrees with this analysis. Just recently, some external observers were still reproaching Europe for focusing on the euro instead of what they considered the more urgent task of implementing the structural reforms necessary for more dynamic job creation.

These critics were wrong regarding the untimeliness of the euro, but their assessment of the ills besetting the European economy is obviously correct. The euro will complement, rather than detract from, structural reforms. Most importantly, a single currency will ease the flow of goods, services and capital within the eurozone. And the euro will also encourage "cross fertilization" of best practices through stronger coordination of member states policies in areas such as labour markets, education and training, work and job creation incentives, effective welfare safety nets, etc..

-The fourth condition is that all economic leaders in Europe must be clear-sighted with regard to the crucial question of competitiveness. Pre-euro economic policy meant monitoring trade balances, the balance of payments and the foreign exchange and interest-rate markets. Governments thus received constant feedback on key indicators affecting national economic performance and could react accordingly. Most of these indicators have disappeared at the national level with the advent of the euro, but, of course, they remain on the euro-wide level. This is why the coordination of fiscal and economic policy provided for by the Treaty is so important. Nevertheless, the rules of a market economy continue to apply to each economy. Jobs are created by consumers when they choose the goods and services they feel are the best value for money. Businessmen allocate these jobs to various possible

locations both in various countries according to the relative competitiveness of these locations. The leaders of each national economy must therefore monitor competitiveness even more closely than before through indicators such as unit production costs, business expenditure and the tax and regulatory framework. Contrary to the pre-euro period, loss of competitiveness will not show up so quickly on radar screens like external accounts and foreign exchange markets, so policy makers must be even more vigilant in watching other indicators. The sanctions for economic policy errors might come more slowly and insidiously via rising unemployment and weak growth.

B. Euro has to be embodied by entrepreneurs, consumers and all the citizens

-Above all, monetary independence, fiscal rectitude, structural reforms and competitive economic policies alone will be fruitless if they are not only embodied in the behaviour of the economic agents themselves, our fellow citizens- households and consumers, but also wage-earners, engineers, entrepreneurs and business leaders. This is the reason why the Banque de France wants to deliver a very straightforward message to companies : "The introduction of the euro is not a tactical issue but a strategic issue". The changeover to the euro does not only mean substituting a currency

denomination for another and changing software programs. It means that all companies' functions - industrial, commercial, financial, etc.. - must be reassessed in order to gauge and implement the necessary strategic changes.

French *companies* are showing increasing interest in the transition to the euro and have set up discussion forums in collaboration with the Ministry of Finance. Recommendations were issued in Spring and Autumn 1997 regarding the accounts, relations with tax and social security services and the conversion of share capital. Bills have been drafted in various fields and finalized in the Parliament. They provide, in particular, for a full euro-option, available for companies since January 1, 1999.

Consultations with consumers have mainly taken place through the National Consumer's Council in France. This consultation will continue throughout the changeover period. Some of the future work to be done involves actions to be taken to help the most vulnerable sections of the population, such as the elderly, and information campaigns aimed at consumers. Some measures will have to be taken to monitor price changes during the transitional period and after 1st January 2002 with full and transparent information from businesses to provide consumers with all the necessary information.

Public authorities, in France, are also fully aware of the need to inform the school children about the euro, because they are the future euro users.

III/ THE EURO SUCCESS WILL YIELD A MAJOR CONTRIBUTION TO A BETTER ECONOMIC AND MONETARY EQUILIBRIUM OF THE WORLD.

In the current overall economic situation the success of the euro will greatly help both Europe and the rest of the world which will gain benefit from European prosperity and growth as part of a healthy world economy.

Clearly, the new monetary setting in Europe has, and will have, far-reaching consequences not only for Europe and its people, but also for the world economy and the international community.

The Euro area contribution to international stability may be appreciated through the development of balanced economic relationships inside the euro area and with the countries outside the European Union, and through the reinforcement of international financial and monetary stability.

3 A. - The setting of balanced economic relationships.

a). *The relationship between monetary union and the other European countries will be based on cooperation.*

Cooperation will chiefly translate into a coordination of the economic policies of the 15 countries of the European Union. Such coordination is required by the Treaty and is necessary for the European Union to function properly on an economic level. It is important that the dialogue between all EU countries continues, even though the changeover to the euro will modify the traditional economic environment of the European Union ; this is the reason why the Euro 11 group, made of the finance ministers of the euro area, has been set up and has already met several times. The dialogue between all parties must take into account the total independence of the ECB and the objective of price stability which, by virtue of the Treaty, will guide monetary policy in the euro area.

In particular, the coordination between the 15 countries will allow the countries that have not yet joined monetary union to converge towards the euro area. The *new exchange rate mechanism* that will link the euro to some of the currencies concerned (this is the case of the Greek drachma and the Danish krone since January 1st 1999) will play its part in this process. By promoting exchange-rate stability, the new

ERM will ensure that the single market operates smoothly and will help the "out" countries to qualify for the single currency.

b). The Monetary Union will also have close relationships with countries outside the European Union.

First, the monetary union and the European Union will be an attractive pole for our neighbours from central Europe. The results achieved by some of them during the last years show remarkable improvements. They must keep on making an effort to be able to join EMU in fitting conditions, which is in their own interest and in the interest of member states of European Union.

With regard to international cooperation, the Euro area will also play a key role. It represents an area of stability and sustainable economic growth for some 290 millions citizens, and it will definitely have a major influence in the international community. The euro will make the international policy cooperation process easier between the main partners - the United States, Japan, and the Euro area. Each of them is in a position to speak on behalf of a comparatively large economic area and is similarly vulnerable to adverse shocks to the international financial system. Therefore it should induce a more balanced relationship in which each of

them will take on responsibility for contributing to a stable global environment.

This major institutional change in the architecture of the international monetary system has made necessary an international representation of the Euro system.

c). International representation of the Eurosystem

The ESCB is already represented at international institutions and fora. Although some decisions are still under consideration, agreements have been reached with the International Monetary Fund (IMF), the Bank for International Settlements (BIS) the Organisation for Economic Co-operation and Development (OECD) and in the G-7 and G-10 context. Most recently, the IMF has granted an observer status to the ECB.

The ESCB enjoys good bilateral relations with other central banks throughout the world.

3 B . - EMU will reinforce monetary and financial stability

a). The international role of the euro

With regard to the international rôle of the euro , let me say that the ESCB takes a neutral stance.

The international rôle of a currency is a complex matter A currency can be used by different groups of

economic agents for different purposes, as an anchor and reserve currency on the official side, and, on private side as an invoicing and payment currency for international trade, as well as currency of denomination for financial assets.

At any rate, it will take time for the euro to develop its role as an international currency in its various functions.

As far as the future share of the euro in the overall official reserves is concerned, it may be expected that central banks of non-euro area countries will progressively reassess their reserve management strategy according to the diversification opportunities offered by this new currency. Besides, the euro might play a greater role as an anchor currency for other European countries which intend to peg their exchange rate to the euro .

As far as private use of the euro is concerned, economic agents may use euro to hedge their risks through portfolio diversification. If international investors and borrowers consider that the euro will be a stable currency, they will hold euro assets to minimize the risks in their internationally diversified portfolios. Moreover a broad and liquid euro financial market may lead to a widespread use of the euro , which , in turn, would facilitate its development as a currency for trade and commodity pricing. The euro will progressively develop over time as an international currency used by the private sector, although the pace of

internationalisation may vary depending on the function.

b) The exchange rate relationships of the euro area vis a vis key global currencies.

As regards the exchange rate relationships of the Euro vis a vis other major global currencies, namely the Dollar and the Yen, I think that one should never forget the following : in a floating exchange system the stability of the exchange rate depends on fundamentals. Therefore sound and wise policies in the monetary and in the fiscal areas are the best recipe for an appropriate functioning of the international monetary system. From that standpoint it is encouraging to note that on both sides of the Atlantic we share the same overall concept of a currency which keeps its value over time and a budget aimed at being close to balance or in surplus.

On top of sound fundamentals which are decisive we need to pursue and reinforce international cooperation. This cooperation has proved useful during the last fifteen years.

Taking stock of the experience and lessons of the last years this international co-operation can probably be improved further, and the fact that three currencies of

G7 countries have now merged in the euro could and should make this co-operation easier, and more and more effective.

In this perspective I would like to draw your attention to four principles, which are key for international cooperation to be efficient.

- the first principle we all have to stick to is the respect of the notion that the fundamentals are commanding the evolution of the exchange rates in the medium and long term.
- the second principle is the necessity to look for an appropriate consensus between the executive branch and monetary authorities and between the various countries concerned.
- the third principle is the respect of what I would call verbal discipline. Markets can be troubled by heterogeneous and contradictory statements. On the contrary they are impressed by the cohesion and coherence of declarations sticking to joint 'terms of reference'.
- the fourth principle is the necessary preservation of the credibility of the authorities in all circumstances.

During the last ten years the joint communiques of the G7 signalling a joint message as regards exchange rates have always been taken very seriously by investors and markets, and proved to be efficient. This is a priceless asset that we must carefully preserve.

As a conclusion, let me stress three points:

As regards the European Central Bank and the European System of Central Banks, I would like to suggest a metaphor which might be enlightening. There is a monetary team of Europe composed of twelve players, the ECB and the 11 National Central Banks.

It is the full monetary team of twelve which is playing on the field, with a single "team spirit, esprit d'équipe" which is one of the priceless assets of Europe.

Secondly, as regards the present level of our interest rates, I would like to draw your attention to the fact that in all economies of the Euro zone market rates are presently the lowest observed since World War II. The level of our long term rates in particular is impressively low and represents a major contribution to preserving growth and job creation. Our three month

money market rate in the Euro zone is presently 150 basis points below the average rates observed in October 1997 and 95 basis points below average three month money market rates at the beginning of July 1998. The Euro is benefiting from the full legacy of the highest level of monetary credibility that had been gained over time in Europe. It is our responsibility to preserve that credibility vis a vis investors and savers in Europe and in the world. It is the only way to maintain a very favourable financial environment for the European economy.

Thirdly, as regards the improvement of the financial architecture which is presently being discussed, I think it is important that we place ourselves in a situation which would permit national authorities, central banks, international financial institutions and surveillance bodies to cooperate actively and thereby keep permanently under review codes of good conduct, best practice and the core principles to be applied both at the macro level and at the micro level, with a view constantly to keeping up with rapid changes in technology, financial instruments and market practices.

I would like to stress one point in particular, the specific dangers that are associated with the "herd instinct" of operators, investors and markets. That "herd behaviour" has been observed during the last 18 months both as regards investors' attitudes vis a vis

emerging economies in transition and certainly also markets of the industrialised countries themselves. The "herd instinct" might be one of the worst enemies when we are aiming at global financial stability. In my opinion one of the best recipes for countering that herd behaviour is full transparency of each particular entity, of each particular country, of each particular borrower, of each particular signature. Only full and reliable transparency for all, both public and private sector entities, permits a proper judgement of the merits of each case. "Comparaison n'est pas raison".

I hope all of us will be inspired by this motto.