

Speech by Mr. 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 New York, at this meeting of Paris Europlace financial forum. 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.

Almost three months 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 number of political and economic actors that the success of the euro is a necessity for Europe. It is a keystone of the European single market which will ensure prosperity in Europe.

It is clear that, now and for the future, we have to face a number of challenges to make this success sustainable. I would like today to draw your attention particularly to the following two issues :

First, the euro area will have to face up to a number of challenges to confirm its initial success (I);

Second, the success of the euro will make a major contribution towards encouraging a more balanced international monetary situation (II).

## **I/ THE SUCCESS OF THE EURO WILL BE COMPLETE IF A NUMBER OF CHALLENGES ARE TAKEN UP**

A few years ago, it was necessary to convince a great number of skeptic people, in Europe but, especially, here in the US, 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 of the economy 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.** The euro is a credible currency and it must and will carefully keep and consolidate the confidence of the 290 million Europeans in the euro area and the confidence of non-Europeans with whom we do business. This can only be ensured by resisting any kind of pressure on how the new currency is managed. Satisfying this first condition will be

facilitated, by the harmonious functioning of the European monetary team, which is composed of the ECB and the eleven national central banks of the Euro area.

- **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 so-called "Euro Eleven" - 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 their own economy.

We have to understand that 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.

- 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.

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

- 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.

- **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 its focus 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 problems of 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. In this sense, the euro-which is in itself a major structural reform-must, and will certainly, bring about other structural reforms.

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 in particular monitoring trade balances, the balance of payments and the foreign exchange and interest-rate markets. Governments thus received constant and to a large extent real time feedback on key indicators affecting national economic performance and could react accordingly.

These indicators remain on the euro-wide level: this is why the coordination of fiscal and economic policy provided for by the Treaty is so important. But they have disappeared at the national level with the advent of the euro, whilst the rules of a market economy continue to apply to each economy participating in the Euro zone. 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 in various countries according to the relative competitiveness of these locations. Therefore the leaders of each national economy must monitor competitiveness through indicators of competitiveness such as unit production costs, the tax and regulatory framework and so forth.

This is even more important than before. Now contrary to the pre-euro period, loss of competitiveness will not show up so quickly on radar screens like external accounts, foreign exchange markets and interest rates 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.

Before turning to the role of the euro in the international monetary system, let me just stress that these conditions are at the heart of the ESCB message to other European authorities. As a matter of fact, when we decided, on April the 8th, to lower the ECB's key interest rates by 50 basis points, to 2,5%, we stressed that this decision was based on a longer term stability-oriented course and we invited those responsible for other policy areas to take the necessary steps to improve longer-term growth prospects for the euro area through decisively adhering to the aims of the Stability

and Growth Pact and through embarking on convincing structural reforms in the economy.

## **II/ THE SUCCESS OF THE EURO WILL YIELD A MAJOR CONTRIBUTION TO A BETTER ECONOMIC AND MONETARY EQUILIBRIUM IN 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 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.

### **A. EMU will help to set balanced economic relationships.**

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

Coordination of the economic policies of the 15 countries of the European Community is required by the Treaty and is necessary for the European Union to function properly at the economic level. It is important that the dialogue between all EU countries continues, even though the changeover to the euro modifies the traditional economic environment of the European Union.

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 links, to the euro, 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 current EU member states.

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 million inhabitants, and it will definitely play its important part in the international community. The euro will make the international policy cooperation process easier among the main partners - the United States, Japan, and the Euro area. Each of them is in a position to speak on behalf of a large economic area. Moreover, each partner is vulnerable to a rather similar degree to adverse shocks occurring in the international financial system. Therefore the euro should induce a balanced relationship in which each partner 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 it necessary, to settle the issue of the international representation of the ESCB.

#### **e). International representation of the ESCB**

As a result of the association of the National Central Banks which compose it, the ESCB enjoys very close bilateral relations with other Central Banks in the world and is already represented in international institutions and fora.

Some decisions are still under consideration, but agreements have been reached on the main practical arrangements, for ESCB representation, with the International Monetary Fund (IMF) which has granted an observer status to the ECB -, the Bank for International Settlements (BIS), the Organisation for Economic Co-operation and Development (OECD) and in the G-7 and G-10 context.

#### **B .EMU will reinforce monetary and financial stability**

##### **a). The international role of the euro.**

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

The international role 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, as an invoicing and payment currency for international trade, as well as currency of denomination for financial assets, on the private side.

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 the 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 remain 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 will progressively 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 widely 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 à vis key global currencies.**

As regards the exchange rate relationships of the Euro vis à 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 the 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 three 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 work out a clear consensus among all partners concerned, namely the executive branches and independent monetary authorities of the various monetary areas concerned.

- the third principle is the respect of what I would call verbal discipline. Markets can be troubled by risky, heterogeneous or contradictory statements. On the contrary they are impressed by the cohesion and coherence of statements sticking to joint "terms of reference".

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In 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 of help to illustrate our views. There is a monetary team of Europe, composed of twelve players, the ECB and the 11 National Central Banks. It is this full, twelve-member monetary team which is playing on the field, with a single team spirit; and this team spirit is one of the priceless assets of Europe.

Secondly, the international concertation in the framework, inter alia, of the G7, has brought further progress in strengthening the international financial architecture. There is sometimes too much emphasis being put, in my view, on the different feelings or positions that appear here and there. What I think is more important is the fact that the international community fully agrees on many key issues. Let me just mention the themes on which we agreed: the importance of principles of "good practice" in the field of social policy, the reinforced supervision of Highly Leveraged Institutions (including hedge funds), the creation of the Financial Stability Forum, the organisation of two seminars with the emerging countries in March and April, the organization of a preparatory meeting of the Interim Committee...

I would like to stress one point in particular, the specific dangers that are associated with the "herd instinct" of operators, investors and markets. This "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 as regards 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.



Thirdly, as regards our present monetary policy, I would like to stress that we are pursuing a strategy of a solid and stable euro, a euro which would inspire confidence. I would also like to stress that the euro has clearly a potential for appreciation.

We will never forget that we are responsible for the confidence in the euro of all savers in Europe and in the rest of the world. It is because savers trust us that we can have low, medium and long-term market interest rates. To sum up, it is by inspiring confidence to savers that we can improve confidence in the constituencies of entrepreneurs, economic agents and borrowers in general.

Confidence in the euro is our most precious good.