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THE EURO AFTER 23 MONTHS
Present situation and prospects

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Ladies and gentlemen, it is a great pleasure and an honour for me to be invited to speak by the Japanese Ministry of Finance and the Japan Center for International Finance. I am particularly happy to express my views on the already successful existence of the euro and Monetary Union, and the conditions and prospects for its further success.

On 1st of January 1999, 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 economic players that the success of the euro is necessary for Europe. It is a keystone of the European single market, which will ensure prosperity in Europe for the benefit of the rest of the world.

I would like to draw your attention to why the euro and Monetary Union have been successful from the outset, and to the conditions and prospects for building on this success.

I. THE EURO AND MONETARY UNION ARE BASED ON A CREDIBLE MONETARY POLICY AND CONTRIBUTE TO AN APPROPRIATE ECONOMIC AND MONETARY EQUILIBRIUM IN EUROPE

I.1. A credible, stability-oriented monetary policy

a/ First of all, let me point out that, from a technical and operational point of view, the launch of the euro on financial markets has been an indisputable success. In this respect, one has to remember all the doubts voiced three years ago.

The decentralised organisation of the Eurosystem has achieved the objectives it was assigned in three important respects:

- operational efficiency, as is demonstrated by the timely adjustment of banking liquidity and steering of short-term interest rates;

- the security provided by the procedures and systems implemented by the Eurosystem, both for the execution of its operations and in the field of large-value payments. At the shortest end of the market, the integration of the interbank market took place last year, right from the start of Monetary Union, thanks to the setting up of the Target system for the transfer of large-value payments in real time throughout the euro area and other EU countries. The system now processes over 4 million payments on average each month, representing roughly 1,000 billion euros daily, of which 43% are cross-border payments. These figures show a significant increase in the use of real-time gross settlements in the EU since the introduction of the euro;

- the smooth functioning of the entire integrated organisation of the Eurosystem, in which the decision-making centre works in constant contact with the national central banks on the implementation of operations.

The reasons for this achievement lie primarily with the in-depth preparatory work conducted over several years by the central banking community and private financial market operators.

b/ Second, together with many other factors, this technical and operational success has contributed to the high credibility of the single monetary policy, which is guaranteed, *inter alia*, by the independence of the European Central Bank and of the national central banks.

The Eurosystem has inherited the store of confidence that was built up over several decades by the national central banks in charge of the most reputable currencies. In France for example, the last opinion survey indicated that 80% of French citizens trust the Banque de France. And the level of confidence in Germany towards the Bundesbank, or in the other countries participating in the euro area towards their respective NCB, is certainly as high.

Moreover, and contrary to what is often said, the monetary union of Europe is not starting from scratch. It is worth emphasising that for no fewer than 12 years before the launch of the euro, five of the currencies which now make up the euro—and represent two thirds of the GDP of the euro area—had proven to be remarkably stable, not being subject to any realignment within the E.R.M.

This high level of confidence is also supported by the homogeneous functioning of the Eurosystem: the European monetary team, composed of the ECB and the national central banks of the eleven and—from next January—twelve euro area countries. All the components of the Eurosystem work constantly hand in hand. The Eurosystem is a single monetary team, with the ECB acting as a coach and the NCBs as the players on the field, with a single team spirit and this team spirit is one of the priceless assets of the euro area.

c/ Third, the credibility of the Eurosystem rests, fundamentally, on its stability-oriented monetary policy strategy. I would like to allay the fears and doubts expressed by some observers as regards the clarity of our monetary policy strategy.

The Maastricht Treaty has given us a mandate for maintaining price stability. We have decided to be as clear and as transparent as possible by announcing a clear definition of price stability, featuring a year-on-year *increase* in the Harmonised Index of Consumer Prices for the euro area of *below 2%.* To reach that goal we have based our monetary policy on two "pillars". As regards the first "pillar" we have set up a quantitative reference value, namely 4.5%, for the growth of the broad monetary aggregate M3. It should be noted that the concept of a reference value does not imply a commitment on the part of the Eurosystem to mechanistically correct deviations in monetary growth in the short term. However, the reference value for M3 is consistent with, and helps to maintain price stability over the medium term.

The second pillar of the monetary policy strategy is a very comprehensive set of indicators that are important in our eyes in signalling future price developments in the euro area.

This strategy, which ensures a great deal of continuity with the monetary policies of the participating national central banks, appears to have been understood by financial markets and the public at large. In particular, the yields on long-term bonds denominated in euros indicate clearly that the Eurosystem has already earned a significant level of credibility.

d/ Finally, the credibility of the euro also results from the Eurosystem's constant efforts towards transparency and communication. I must stress here that the Eurosystem is one of the most transparent central banks in the world. Once a month, immediately after the meeting of the Governing Council, the President of the ECB holds a press conference- which starts with a precise exposition of the diagnosis of the Governing Council which is immediately made available in real time on the ECB website.

It is extremely important to stress that the Eurosystem was the first in the world to introduce, on the 1st January 1999, the concept of regular, frequent, real-time transparency in the domain of monetary policy. This illustrates the extent to which some criticisms are profoundly unjust ! It is especially noteworthy, in this regard, that soon after we had embarked upon this new concept of real-time transparency, the Federal Reserve System itself decided to go along the same path.

Being accountable for an independent institution in a modern democracy or, as it is the case for the Eurosystem, in a subtle set of democracies like the European Union, means being accountable to public opinion at large.

In this respect, the public speeches and testimonies of the President of the ECB for the benefit of both European institutions and public opinion, the public speeches and testimonies of the Governors of the National Central Banks to national institutions and public opinion, are crucial. Explaining tirelessly the reasons and the reasoning that underpin the decisions of the Governing Council is a key part of our collective duty. This intertwining of the communication of the European monetary team with the European and national institutions and the full body of the civil societies is currently underestimated. Wim DUISENBERG attends hearings at the European Parliament in Brussels more often than Alan GREENSPAN does on the Hill in Washington. Each national governor explains in his own language (so in total in nine languages), through the lens of eleven and tomorrow twelve different cultures the same message from the Eurosystem.

In terms of transparency and accountability—namely the duty to explain, justify, whenever possible convince, and in any case, being fully responsible vis-à-vis public opinion for decisions taken- I think that the Eurosystem meets the best practices of the main central banks in the world.

I.2. Co-ordination of economic policies

A few years ago, it was necessary to convince a great number of skeptical people, in Europe as well as in the rest of the world, that the euro was really to be set up. Many observers pointed to its presumed contradictions and alleged inconsistencies: claiming, for example, that the economic divergences and structural gaps among euro-area countries would be too large to ensure a viable monetary union or that the lack of co-ordination between economic policies would deprive the area of an appropriate *policy-mix,* and could not be achieved without a political federation. Other objections raised were the absence of instruments to respond to any *asymmetric shocks,* and the European economies' lack of flexibility and real mobility in the labour force. The conclusion was that the euro would never exist ! The facts have disproved this conclusion. But the very same arguments are now deployed to suggest that the euro-area economy is full of deep and profound inconsistencies that could endanger its prosperity.

What can we say, from an economic standpoint, on this very important question?
Firstly, that monetary union *per se,* and wherever it takes place, does not necessarily imply that, at any given point in time, all the participating countries will experience the same rate of inflation or of growth, even though the move to the euro was based on the successful completion of a convergence process.

Let us focus, for example, on inflation. Present differentials do not appear to be very large, in comparison with the experience of the United States, a long-established monetary union of comparable size. Data on major cities of the US shows that inflation differentials have been at times very substantial, with divergences of 7 percentage points being recorded in the early 1980s.

In the euro area, long-term convergence to a common level of prices gives naturally rise to differences in inflation rates across EMU countries. The convergence of productivity and living standards creates a trend towards price convergence, as a consequence of the commonly known *Balassa-Samuelson effect*. According to the IMF, this effect is estimated to have contributed 1.5-2.0 percentage points per annum to inflation for EU countries catching up on productivity.

The recent statistics available for the United States also confirm that wage and salary differentials within the euro area are by no means atypical in a monetary union : for example, in the US the average weekly earnings in the non-durable goods sector work out at USD 540 at the national level, while standing at USD 437 in Mississippi and USD 644 in New Jersey.

I am convinced that we can be reasonably confident in the increasing integration of European countries, and in the fact that economic developments are becoming more and more correlated in the area. It has been highlighted, in the academic field, by several empirical investigations that business cycles are becoming more synchronous across Europe.

Secondly it has often been questioned whether EMU can be a success without some form of enhanced political union. Certainly, for EMU to function well, all Member States must be aware of the spill-over effects of all their national policies, especially their budgetary policies.

In this regard, we are in favour of strong co-ordination between economic policies, while respecting the independence of the Eurosystem. This co-ordination is contained in the Treaty itself, which obliges Member States to treat national economic policies "as a matter of common interest" and subjects them to a multilateral procedure.

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Even more importantly, the euro zone is not devoid of mechanisms conducive to an appropriate policy mix. As a matter of fact, monetary policy alone cannot ensure price stability without the appropriate fiscal discipline at the overall EMU level. Indeed, for my part, I would mention three economic justifications for the Treaty provisions that gave rise to the Stability and Growth Pact:

- First, by co-ordinating 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, to counterbalance the fact that Europe does not have a significant federal budget, just as it has no federal government. Close mutual surveillance and co-ordination of fiscal policies are the responsibility of the "Euro Group" and of the Ecofin Council. Adherence to the medium-term objective of achieving budgets that are "close to balance or in surplus" means that individual countries must first rely on themselves to withstand possible economic downturns which affect only their own economy, while ensuring a balanced policy mix throughout the euro zone.

- Second, the pact helps to prevent well-managed economies from having to bear an unjustified risk premium by setting up a penalty system for excessive deficits.

- And lastly, the stability and growth pact allows us to disprove the assertion that the euro area has no automatic stabilisers in the event of asymmetric shocks to a member economy. Indeed, by urging governments to aim at a fiscal position "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 to counter economic divergences or asymmetric shocks.

To summarise that overall issue, the "*Optimal Currency Area*" theory has frequently been called upon by economists who criticized EMU and expressed concerns about giving up the exchange-rate policy instrument as a response to asymmetric shocks—in particular to asymmetric shocks within a monetary union. I would like to point out, first, that one of the most remarkable effect of the European integration has been the increasing symmetry of shocks. Second, Professor Mundell himself, in support of

EMU, made an interesting clarification at the beginning of 1998: in the event of a shift in demand from one member country to another, creating unemployment in the first and inflationary pressure in the second, flexible exchange rates would not be able to solve the problem. I quote: "*If the argument for devaluation were valid, it could be applied to every state or sub-region in any country, with a proliferation of new currencies, so they could be devalued!*". In the same vein, other economists suggest that dealing with divergences and asymmetries should not prove much more difficult within the euro area, at least in its major countries, than within a long-established monetary union such as the US.

II. THE EURO AS A CATALYST FOR FURTHER PROGRESS

While many acknowledge that the introduction of the euro has been successful, one may ask at this point what needs to happen to continue ensuring the success of the euro in the medium term. What is very encouraging in this respect is the fact that in a number of areas the euro itself appears to be as a catalyst for these conditions to be met.

II.1. The euro and the single market

a/ The euro is the crowning achievement of the single market. Need we mention the advantages inherent in the single market? It enables the productive sector to make significant economies of scale and allows savings to be allocated to the most efficient investments. It also enhances market visibility and boosts competition and innovation to the benefit of consumers. But the ultimate objective of the single market could not be achieved while monetary barriers continue to prevent the free flow of goods, services, capital and, in a way, people, by imposing unpredictable and erratic exchange-rate movements and transaction costs. The last step in this process will be made with the cash changeover at the end of 2001; it will enable not only enterprises but all our citizens to enjoy all the advantages of using the same monetary instrument throughout the European continent, just like Americans do today throughout the territory of the United States.

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b/ Moreover, the introduction of the euro brings about a significant change in the economic and financial environment.

The introduction of the euro has been a strong catalyst for mergers and acquisitions in the euro area. The European M & A market seems to be the most dynamic in the world: with operations totalling over 1,000 billion dollars in 1999, it is now catching up on the American market.

The euro has brought about significant changes for participants in financial markets and has fostered structural developments in the financial industry. This is true both on euro-area money markets and on capital markets.

- From the beginning of Stage Three of EMU, cross-border transactions in the money market increased so as to represent more than 50% of the total activity in all segments of the money market. The unsecured deposit interbank market—which is mostly concentrated on shorter maturities—exhibits a very high degree of integration. The integration of interest-rate markets within the euro area is a key achievement which deserves to be underscored. EONIA and EURIBOR have provided the market with uniform benchmarks fully accepted by all market participants. The diagnosis is the same in the short-term derivatives market, whose integration, standardisation and depth have increased. This is reflected, for instance, in the scale of daily transactions and the huge expansion of the euro interest-rate swap market.

  These structural changes in the euro area money market have generated significant moves by market participants, who have concentrated their euro cash management activity and have benefited from better liquidity on the secondary market. Of course, such integration has to be brought to fruition in the other segments of the money market, i.e. the repo market and the short-term securities market. Further integration will enhance the efficiency of the euro area financial markets and will be beneficial to borrowers and investors alike.

- With regard to the capital markets, progress towards integration has been significant, both on the euro-denominated bond market and the equity market.

The gross issuance of long-term debt securities denominated in euro amounted to 791 billion euro in 1999, against the equivalent of 902 billion euro for debt securities denominated in US dollars. The pace of euro-denominated issues remained brisk in the first half of 2000 at 372 billion euros. According to the Bank for International Settlements, euro-area private sector borrowers have issued 76% of their debt in euros since 1 January 1999, compared with an average of 50% in the predecessor currencies since during the 1990s. Similarly, private borrowers resident outside the euro area issued more than a fifth of their international debt in euros from the beginning of 1999, roughly a twofold increase over the total share of the legacy currencies before the introduction of the euro. Furthermore, European investors have substantially diversified their bond portfolios since the introduction of the euro, encouraged by the removal of the exchange rate risk. This enables them to achieve higher rates of return for a given level of portfolio risk.

Additionnally, let me recall recent trends towards mergers or close co-operation between stock exchanges, securities settlement systems and clearing houses, and so forth. Had the euro not been created, would it have been thinkable that the Paris, Brussels and Amsterdam exchanges would merge, creating EURONEXT? It is evident that the introduction of the euro is fostering very large-scale market restructuring throughout Europe. The total stock market capitalisation of euro-area equity markets stood at more than 5.5 trillion euros at the end of 1999, compared with a market capitalisation of 3.6 trillion euros at the end of 1998. This figure reflects not only the increase in stock prices but also the powerful drive towards securitisation of private companies throughout Europe and, in particular, the take off of the "new markets" network.

There are still some barriers to further integration of EU capital markets. In this regard, the Eurosystem has welcomed the objective of the European Council, meeting in Lisbon in March 2000, of accelerating completion of the internal market for financial services, and to set a tight timetable so that the Financial Services Action Plan is implemented by 2005.

II.2. An incentive for further structural reforms

a/ The Euro is, per se, also a strong catalyst for structural reforms in all non-financial domains in Europe : a single currency facilitates the full comparison of prices, taxes and earnings. I think that the euro could encourage "cross-fertilisation" of best practice through stronger co-ordination of Member States' structural policies in areas such as labour markets, education and training, job creation incentives, effective welfare safety nets, etc. It is the reason why the European Council, meeting in Luxembourg in December 1997, explicitly mentioned structural policies among the items selected for reinforced co-ordination. The Lisbon European Council made a further contribution to the necessary medium-term strategy for structural reform in the Union. The emphasis put on deepening the single market, the setting of indicators allowing comparisons of best practices among the Member States, the fact that the Broad Economic Policy Guidelines will examine the structural issues closely : all these developments are going in the right direction.

All European countries must resolutely carry on the structural reforms they have already initiated. It must be acknowledged that a lot has already been done, in particular with implementation of the single market. However, continental Europe is still experiencing levels of unemployment that are too high, despite the fact that the jobless rate has been declining significantly in most of its economies for three years. According to the IMF and the OECD, around 80% of this unemployment level appears to be structural, that is, generated by our own burdensome rules and regulations.

EMU certainly stimulates structural reforms in the labour market. With increased capital mobility and a better functioning single market, firms will become more and more sensitive to overall labour cost differentials and business regulations in choosing a particular location in the euro area. They will therefore exert a considerable pressure for appropriate reforms.

b/ In addition to structural reforms, a strong emphasis must be put on competitiveness.

Pre-euro economic policy meant monitoring the balance of payments and the foreign exchange and interest-rate markets. The authorities thus received constant feedback on key indicators affecting national economic performance and could react accordingly. These indicators were sensitive, multiple and very reactive.

In contrast to the pre-euro period, a loss of competitiveness will not show up quickly on radar screens like foreign exchange markets, interest-rate markets or the external accounts. As a result, economic managers must monitor the relevant competitiveness indicators with even greater vigilance. The sanctions for economic policy errors could come more slowly and insidiously via rising unemployment and weak growth.

The rules of a market economy, especially competition, 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 in various countries according to the relative competitiveness of these locations. It is therefore necessary to monitor competitiveness even more closely than before through indicators such as unit production costs and the tax and regulatory framework.

The close multilateral surveillance and the frank discussions provided in the context, *inter alia*, of the Eurogroup, will help monitor competitiveness trends with a view to ensure early warnings and appropriate reactions.

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Let me address, in conclusion, two issues: growth and confidence in the future of the euro.

Growth: Central bankers are sometimes portrayed as being excessively cautious and reserved with respect to economic growth. On the contrary, we are very much in favour of growth. First and foremost, because the objective of monetary policy—price stability—is a necessary condition for long-term, robust growth. At the end of the press conference following the ECB Governing Council_on 2 November, Wim

DUISENBERG said very clearly on behalf of all of us that "monetary policy will not accommodate inflationary tendencies in the euro area and in this way will make its best contribution to sustainable growth".

Not only are we aiming at sustainable non-inflationary steady growth through our action but also via all our recommendations. We are resolutely anti-Malthusian in all fields of the economy, that is we support innovation, liberalisation and growth incentives.

We are anti-Malthusian as regards scientific and technical progress. We feel the new technologies should be approached with an open mind so as to broaden our scope of economic activity and derive the best possible productivity gains from these advances, together with the corresponding positive impact on production costs and prices.

We are anti-Malthusian as regards labour. It is essential to ease the bottlenecks in all sectors reporting a significant shortage of skilled labour in order to continue to contain production cost increases—and thus ensure price stability—and to allow unfettered growth. In this respect, we all welcomed the objectives of the European Council in Lisbon, which aim at boosting the labour force participation rate in Europe from 61% to 70% and increasing the supply of "new economy" skills. This is a very important decision which represents a conceptual turning point.

We are anti-Malthusian as regards investment. We would like it to be as dynamic as possible, in terms of both capacity and productivity, in order to loosen production capacity bottlenecks, preserve production costs, which is good for price stability, and allow unfettered growth. More than ever, the time has come to invest in Europe.

We are also anti-Malthusian as regards the liberalisation of trade. An open-minded attitude in this respect has the advantage of consolidating and strengthening price stability, increasing the purchasing power of consumers and encouraging long-term growth.

Confidence: The success of the euro will yield a decisive contribution to an appropriate economic and monetary equilibrium in the world. In the current overall economic situation, the success of the euro will help both Europe and the rest of the world. Indeed, the euro-area's partners—in particular the United States and Japan—have a joint interest in global prosperity and growth. And each partner is vulnerable to adverse shocks occurring in the international financial system.

And the communiqué of the G7 following the concerted intervention of the main central banks itself is crystal clear : "*at the initiative of the European Central Bank, the monetary authorities of the US, Japan, United Kingdom and Canada joined with the E.C.B. on Friday, September 22, in concerted intervention in exchange markets, because of the shared concern of finance ministers and governors about the potential implications of recent movements in the euro for the world economy.*" This intervention was followed by several rounds of intervention by the Eurosystem. Interventions on foreign exchange markets are not words : they are acts which speak by themselves.

Finally, if I had to sum up the European position, entirely shared by the members of the Governing Council of the ECB and also shared by the Ministers of Finance, I would say : "A strong euro is in the interest of Europe".

Thank you for your attention.