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"THE EURO AFTER 22 MONTHS"

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Ladies and gentlemen, it is a great pleasure and an honour for me to be speaking here, in London, at the invitation of the Southbank University, in front of such a distinguished audience. 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. The euro is based on 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 decentralized organization of the Eurosystem has achieved the objectives it was assigned in three important aspects :

- **operational efficiency**, as is demonstrated by the precise 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 the operations and in the field of large-value payments. At the shortest end of the market, the integration of the inter-bank market took place last year, **right from the start of EMU**, 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 23 trillion euros of which 42 % 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 organization of the Eurosystem**, in which the decision-making centre works in constant contact with the national central banks on the implementation of the operations.

The reasons for this achievement lie primarily with the in-depth preparatory work conducted over several years by the central banking community and by 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 zone, 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 less than 12 years before the launch of the euro, six currencies which are now making 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 guaranteed by the homogeneous functioning of the Eurosystem: the European monetary team, composed of the ECB and the national central banks of the eleven and, as 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 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, particularly in this country, 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 HICP 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 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 maintaining 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 euro are clearly indicating 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, 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 the 1st January 1999 the concept of regular, frequent, real-time transparency in the domain of monetary policy. This illustrates to which extent some criticisms are profoundly unjust ! It is very 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 the public opinion at large.

In this respect the public speeches and testimonies of the President of the ECB to the attention of the European Institutions and public opinion, the public speeches and testimonies of the Governors of the National Central Banks to the attention of the national Institutions and national public opinions are decisive. Explaining tirelessly the reasons and the reasonings that underpin the decisions of the Governing Council is a crucial 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 is participating more often in hearings with the European Parliament in BRUSSELS than Alan GREENSPAN is on the Hill in WASHINGTON. Each national governor explains in nine different languages, through the grid of eleven - and, tomorrow, twelve – different cultures the same message of 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 standards of the main central banks in the world.

I.2. The euro contributes to growth in Europe by enhancing the 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,* which 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 ! Facts have disproved this conclusion. But the very same arguments are now utilized to suggest that the Euro zone economy is full of deep and profound inconsistencies that are putting in danger 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 of 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. Who knows that data on major cities of the US show 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 *latest* statistics available for the United States confirm that wages and salaries differentials within the euro area are not necessarily atypical for a recently-established monetary union: for example, the average weekly earnings in the non-durable goods sector work out to USD 546 at the national level, while standing at USD 437 in Mississippi and at USD 644 in New Jersey.

Significant disparities may even exist between the regions of a single-state country. A recent article published by the *Financial Times* presenting the results of the latest official survey of the UK's regions shows, for example, that per capita GDP was highest in London at £ 16,200 in 1999, followed by the south-east at £ 14,500, compared with only £ 9,800 in the north-east. People living in London enjoyed average weekly earnings of £ 520, compared with a UK average of £ 399 and, therefore, much lower earnings in the so-called "depressed areas". These differences might not diverge so much from the gaps observed between the economies of the euro zone within an integrated economic area of 293 millions inhabitants.

My intimate conviction is 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. This has been highlighted, in the academic field, by several empirical investigations : I would mention authors like *Artis and Zhang* who found evidence 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**. Indeed, a well-functioning EMU means that all

Member States must be aware of the spill-over effect of all their national policies, especially their budgetary policies.

In this respect, we are in favour of strong co-ordination between economic policies, in full respect of 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 concern" and subjects them to a multilateral procedure.

Even more importantly the euro zone is not devoid of the 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 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 summarize on that overall issue, the *"Optimal Currency Area"* theory which was developed by *Mundell* as early as 1961, has frequently been called upon by economists who criticised EMU and expressed concern about giving up the exchange rate policy instrument as a response to asymmetric shocks – in particular to asymmetric shocks within the monetary union. 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, I could also refer to other economists such as *Bayoumi and Eichengreen,* who suggest that dealing with divergences and asymmetries should not prove much more difficult within the euro area than within a long-established monetary union such as the US.

II. THE EURO ITSELF IS A CATALYST FOR FURTHER PROGRESS

While many should acknowledge that the introduction of the euro has been broadly successful, one may ask, at this point, what are the conditions for a full 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 as a catalyst for these conditions to be met.

II.1. The euro deepens and completes 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 impredictible and erratic exchange rates movements and transaction costs. The last step in this process will be made with the cash changeover at the end of next year; it will enable not only enterprises but all our citizens to 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.

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 merger and acquisitions in the euro area. The European M & A market seems to be the **most dynamic in the world** : with operations totalling over USD 1 trillion in 1999, it is now catching up on the American market.

Moreover, the euro has brought about significant changes for participants in financial markets and has fostered consolidation in the financial industry. This is true both on euro area money markets and on capital markets.

- As 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 inter-bank 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 a uniform benchmark 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 amount of daily transactions and the huge development 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 both borrowers and investors.

- 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 836 billion euro in 1999, against 634 billion euro for debt securities denominated in US dollars. These figures soared to EUR 228 billion and EUR 182 billion, respectively, in the first quarter of 2000. From January 1999 to end-March 2000, according to the Bank of International Settlements, euro area private sector borrowers issued 76% of their debt in euros, compared to an average of 50% in the predecessor currencies as from the beginning of the decade. Similarly, private borrowers residing outside the euro area issued more than a fifth of their international debt in euros since 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, fuelled by the removal of the exchange rate risk. This enables them to achieve higher rates of return for a given level of portfolio risk.

Additionally, let me recall recent announcements regarding mergers or close co-operation between stock exchanges, securities settlement systems, clearing houses, and so forth. Had the Euro not been created, would have it been thinkable that the Paris, Brussel and Amsterdam exchanges would merge creating EURONEXT ? It is visible 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, to accelerate 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. The Euro is 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, earnings. I think that the euro could encourage "cross fertilisation" of best practices 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 the 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 on labour market. With increased capital mobility and a more perfect functioning of the 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/ Besides structural reforms, a strong emphasis must be put on the **competitiveness issue.**

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

Contrary to the pre-euro period, loss of competitiveness will not show up quickly on radar screens like exchange markets, interest rates markets or 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, three questions : growth, confidence in the future of the euro and the entry of sterling in 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. That is the reason why the Governing Council has decided to increase our rates by 25 basic points during our last meeting. Wim DUISENBERG said very clearly on behalf of all of us that it is important to address potential inflationary risks "in order to preserve steady GDP and employment growth in the medium term".

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.

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%. 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 France and throughout 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, Europe's partners —the United States and Japan— are interested in and associated with European prosperity and growth as part of a healthy world economy. And each partner is vulnerable to a rather similar degree to adverse shocks occurring in the international financial system. In this respect, the recent joint intervention in foreign exchange markets by the main central banks in the world speaks by itself and is self-explanatory.

And the communiqué of the G7 itself is cristalclear ; I quote : *"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."*

As regards the position of the Eurosystem itself it is equally cristalclear and I cherish a very eloquent short sentence to sum up our consensus : "A strong euro is in the interest of Europe".

UK entry in the euro : Speaking here, in London, I cannot help mentioning the question of the entry of Britain in the Euro zone. I would like to stress the following points :

- first of all, we should never forget that the UK is unanimously and warmly welcome in the Euro area. It depends only on the decision of the British people and of the British authorities to join in. That situation compares extremely favourably with the episode of the entry of the UK in the EEC when the UK was willing to join in and the EEC hesitating to accept her. Everybody on the continent is very warmly hoping for a positive decision by the UK.
- Secondly, I hope that I have been sufficiently convincing in this exposition that the euro is the necessary last major tool for achieving the single market that has been so strongly and unanimously supported by the UK. It is highly paradoxical – and even, in a way, bizarre - that the UK hesitates to pursue and achieve her own cherished single market endeavour.
- And, thirdly, let us not forget the figures. The first January 2001, 12 members of the European Union out of 15 will be members of the Euro area, i.e. four fifth of the member states. These 12 members will represent four fifth of the European citizens, namely 304 million out of 377 and four fifth of the consolidated GDP of the European Union. The economic advantages of participating fully in such a very large single market with a single currency are such that economic leaders all over the Euro area are fully supporting this extraordinary structural reform.

May be you will forgive me to be so visibly in favour of the UK joining in. May be I have also personal reasons ! Being a French "breton" myself I cannot forget that a number of my ancestors were living in Britain. I cannot forget that in the time of the Roman Empire all "Bretons" were in the British Isles. And I cannot forget that when a French Breton refers to the old legends of Bretagne, to King Arthur, to Merlin and to Melusine, he refers to a single concept of Bretagne which is merging Great Britain and French Brittany as if the Channel did not exist.

Thank you for your attention.