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"The euro after five years: assessing its performance and global role"

Speech by

Lucas Papademos,

Vice-President of the European Central Bank,

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European Central Bank
Press and Information Division
Kaiserstrasse 29, D-60311 Frankfurt am Main
Tel.: 0049 69 1344 7455, Fax: 0049 69 1344 7404
Internet: http://www.ecb.int

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I. Introduction

The organisers of this prestigious international monetary symposium have invited me to be the first speaker this afternoon. This puts me in the privileged position to open the discussion and, in this way, to set the scene and the tone. I am delighted to be here, among such highly esteemed speakers, at this event to mark five years of the euro. Five successful years. Of course, “success has many fathers”, as the saying goes. But as the central bank issuing the euro, the European Central Bank has a particularly close “parental” relationship and responsibility. And that parental feeling, in fact, applies to the Eurosystem, which comprises both the ECB and the national central banks of the euro area.

The particular focus of our symposium today is on the implications of the euro for Asia. But before we look at the future implications of the euro, I thought it would be part of our “parental duty” to also look back on how the euro has developed, to take stock and put together a kind of scorecard of the performance of the single European currency: in what fields does the euro deserve straight “As”? And where would further efforts be needed to get to the top of the class? In the second part of my talk, I will address issues related to the international role of the euro.

II. The euro’s scorecard after five years

Looking back on the period since the introduction of the euro in 1999, I will simply let the facts speak for themselves: during the first five years of the existence of our new currency, the average rate of inflation in the euro area has been precisely 2% which is in line with the ECB’s definition of price stability. Even though inflation has occasionally risen above the 2% ceiling – as has been the case in recent months – this was a consequence of a number of shocks of various types, the most recent being the oil price shock. As the ECB’s monetary policy strategy has a clear medium-term orientation, our response to supply shocks and euro area-specific shocks has been measured. What should be emphasised, however, is that in these first years of the euro’s existence, inflation expectations have remained firmly anchored to a rate close to, or less than, 2%, as can be inferred from the yields of index-linked long-term bonds. Clearly, the markets and the public have confidence in the euro and in the ability and determination of the ECB to maintain price stability.

Today, this record sounds like a simple statement of fact. But for a central banker, it represents a great accomplishment and an indispensable asset for monetary policy-making – credibility. It is often said that credibility is easy to lose and nearly impossible to regain. The ECB, as a new central bank without a track record, had to gain it in the first place. Back in 1999, many observers expected that the quality of the new currency, in terms of the stability of its purchasing power or the associated prevailing level of market interest rates, particularly at the long end of the yield curve, would be something like the average quality of its legacy currencies. What we have witnessed instead is convergence towards the best performer. The euro area today is a zone of monetary stability, and interest rates are at levels last seen more the five decades ago. All of this provides very favourable conditions for economic growth. That these conditions have, unfortunately, not proved sufficient to support a high rate of sustainable growth is due to the constraining influence of other, non-monetary, factors.

Another factor underpinning the confidence of the European public in their new currency is the quality and integrity of euro banknotes and coins as well as the smoothness with which they were introduced. The "cash changeover", by now almost three years ago, was a very complex operation involving an unprecedented logistical effort. Some 15 billion euro banknotes and 50 billion coins were prepared, produced and distributed, so that on 1 January 2002, over 300 million European citizens could hold the euro in their hands. Thanks to the thorough preparation by central banks, financial institutions and the private sector, the launch went very smoothly; the chaos predicted by some commentators never materialised. And European citizens welcomed the new currency with an unexpected enthusiasm.

All in all, I would say, the euro deserves straight "As" in fundamental areas, and more notably, as a stable and trusted currency. However, I do not wish to deny and conceal that there have been also some areas where things could have been done better, or where improvements can – and should – be made.

For example, we have to acknowledge that the cash changeover did have some undesirable effects on prices, in connection with their conversion from national denominations into euro. The irritation caused by some disproportionate price increases, especially in parts of the service industry, in a number of euro area countries, gained a lot of unfavourable publicity. Even though our statistics show that the cash changeover had a rather small one-off impact on inflation of around 0.1% to 0.3% on average across the euro area, people had the impression that inflation was much higher than the recorded change in the consumer price level. This gap between "perceived" inflation and actual inflation has gradually got smaller, though at a puzzlingly slow pace.

We should not forget either that the introduction of the single European currency represented a fundamental regime shift which clearly required certain adjustments in the way monetary policy-makers communicate with markets and the public. In 1999, the ECB was a new, unknown central bank; it had no history of decision-making. Its two-pillar monetary policy strategy was a novelty in the world of central banking; its economic environment was, and is, a heterogeneous, multi-country economy, and its political setting unlike anything we know from the nation-state. It is therefore hardly surprising that communicating the ECB's monetary policy has been a real challenge which has meant for all of us – the Eurosystem at the sending end, and the markets and the public at the receiving end – a process of learning and adapting. It also took some time for the markets to fully understand our monetary policy strategy, that is, the conceptual framework on the basis of which the Governing Council assesses the economic outlook and the risks to price stability, takes decisions about the appropriate monetary policy stance, and explains these decisions to the markets and the public. By now, the understanding of our strategy has greatly improved, and the recent evaluation and clarification of the strategy has certainly helped to this end. The ECB today ranks as one of the most open, transparent and predictable central banks in the world, and we continually seek to improve our communication.

Overall, a lot has been achieved on this front, but improvements can still be made in other areas. For instance, much more progress remains to be made in respect of the integration of European financial markets. As economic theory would predict, the single currency has eliminated exchange rate risk and lowered transaction costs. This has indeed significantly reduced borrowing costs in the euro area. Deeper, broader and more liquid continent-wide financial markets have emerged, which have reduced liquidity risk premia, improved access to external finance and cut financing costs. Thanks to the credibility of the ECB's monetary policy, the euro area's low inflation environment has reduced inflation risk premia, and interest rates have remained lower and more stable across the maturity spectrum than would otherwise have been the case. All very positive indeed, I would say, but not quite "top of the class". If we take the deep, liquid and unified US financial markets as a benchmark, the euro area clearly still has some way to go, especially as regards the integration of equity markets, the establishment of common legal and regulatory frameworks, and the consolidation of the banking sector.

So, if we add it all up and look at the euro's scorecard after five years, I would say the result looks quite impressive. However, having extolled the successes of the euro "at home", I do not want to create the impression that Europeans have a particular penchant for navel-gazing and that Europe is "obsessed with its own internal dynamics." So now I will turn to the global impact of the euro, and notably its international role, a very fitting subject for this international symposium.

III. The international role of the euro

Back in 1998, before the launch of the euro, some policy-makers and economists predicted that the euro would quickly develop into an international currency. The new single currency zone would represent the world's largest trading area and an economy with a combined gross domestic product of some €7 trillion. And the euro's legacy currencies, notably the Deutsche Mark, had already established a certain international status. Some expected – or even hoped – that the international role of the euro would rival that of the US dollar. I should add that among central bankers, we always refused to frame the discussion in such terms.

Five years on, where do we stand? The international role of a currency is a complex phenomenon, so let me first look at the international *private* use of the euro, that is, its use by international borrowers, investors and traders. Afterwards, I will consider the international *official* use of the euro, that is, its use as an intervention, reserve and anchor currency. I will conclude with a few observations on the use of the euro as a parallel currency in some countries in Europe.

III.1. The international private use of the euro

The euro is today the second most widely used currency internationally, in capital markets, in foreign exchange market trading and in international trade. In international capital markets, our data for early 2004 show that the share of the euro in international debt securities gradually increased to around 31%, compared with a share of less than 20% for the legacy currencies prior to the launch of the euro.[1] By comparison, the share

[1] Data is provided for the "narrow" concept of international issuance of debt securities (i.e., bonds and notes, as well as money market instruments), which is defined as issuance in a currency different from the currency of the country in which the borrower resides.

of the US dollar has decreased slightly (from 47% in 1999 to 44% in 2004), and that of the Japanese yen has also declined (from 17% in 1999 to 9% in 2004).

What is particularly noteworthy is that the euro, both as an international financing and investment currency, has a strong regional focus. An analysis of the geographical breakdown of the outstanding stock of euro-denominated international debt securities shows that European countries near the euro area account for the largest share of issues of these securities. Moreover, the increase in the use of the euro as an investment and financing currency, relative to other currencies, has also been highest among residents of countries neighbouring the euro area. By contrast, borrowers in Asia, Latin America and the Middle East have continued to issue only a small fraction of their international bonds in euro.

Holdings of euro-denominated debt securities are very small in portfolios held in the United States. They are also small in Asia, but growing. It is in the countries neighbouring the euro area, such as the UK, Switzerland and non-euro area Nordic countries that such holdings are particularly high. The City of London is one of the main financial centres using the euro and corporations often use London-based specialised intermediaries to issue euro-denominated bonds outside the euro area.

A third feature of the role of the euro in international capital markets is that it is partly driven by the euro area residents themselves, as investors (both retail investors and banks) from the euro area have bought a significant share of euro-denominated bonds issued in international markets. This is especially the case in international debt markets. Likewise, a significant share of euro-denominated financial activity in the City of London originates from euro area-owned banks. These hold around 40% of euro-denominated assets of UK-resident banks.

Let us now take a closer look at the foreign exchange markets. The euro is today the second most actively traded currency in foreign exchange markets worldwide, accounting for 37% of foreign exchange transactions.[2] This share has remained stable over the past couple of years. Globally, the euro has continued to be traded predominantly against the US dollar, as more than three-quarters of total worldwide foreign exchange activity involving the euro has been with the US dollar.

[2] Data from the BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, conducted in April 2004. Similar evidence can be derived from foreign exchange trades settled via the Continuous Linked Settlement (CLS) where in 2003 and 2004 the euro accounted for around 44% of all settlements, a slight decline compared to the 2002/2003 when the euro share stood at roughly 48%.

Finally, the euro is an important invoicing or settlement currency in international trade, which is a natural consequence of the euro area being the world's biggest trading bloc. Our data show that in most euro area countries, the use of the euro seems to be more widespread for exports than for imports, and, in particular, for the exports of goods more than for the exports of services. Interestingly, we now have some indications that the euro is also being increasingly used in the international trade of EU countries that have not yet adopted the euro as their own national currency, even when trading with third countries. We derive this conclusion from data for most of the new Member States and the candidate countries[3], where, in the course of 2003, the share of the euro as an invoicing or settlement currency in international trade increased markedly, and more so than the growth in their trade with the euro area.

III.2. The international official use of the euro

What is the international *official* use of the euro, that is, its use by government authorities and central banks as an anchor, reserve and intervention currency? Before answering the question, I should emphasise that the functions of anchor, reserve and intervention currency are intricately intertwined. Under a floating exchange rate regime, foreign exchange market interventions are infrequent, as they are mainly conducted to calm disorderly market conditions. By contrast, countries operating any form of exchange rate peg and managed float intervene regularly so as to ensure that the respective exchange rate is consistent with the chosen regime. In conducting such interventions, they prefer to use the anchor currency which then also serves as their main reserve currency.

Today, roughly 50 countries use the euro as an anchor or reference currency in their exchange rate policies. While the composition of this group of countries has changed somewhat in recent years, the total number of countries has been stable. Indeed, the use of the euro in third countries' exchange rate regimes has a strong geographical and institutional underpinning, with many of these countries being close to the euro area, including most non-euro area EU member states, or having special institutional arrangements with the European Union, like the candidate countries, potential candidate countries and the countries of the CFA Franc Zone in West Africa. Overall,

[3] Bulgaria, Croatia, Romania, Turkey

most of these countries are located in eastern and south-eastern Europe, in the Mediterranean and the Middle East and sub-Saharan Africa.

With regard to the use of the euro as a reserve currency, you are probably all aware that the relevant data are extremely difficult to obtain. What we do know is that from 1999 to 2003, global foreign exchange reserves rose by more than USD 1.3 trillion to about USD 3 trillion. By far the largest share of this increase is attributable to reserve accumulation in a few countries in Asia as well as in Japan, Russia and Mexico. These are countries which conduct an exchange rate policy which is either *de jure* or *de facto* oriented towards the US dollar. From this development, it could be inferred that most of the reserve accumulation probably pertained to the US dollar. Against this background, and bearing in mind that most countries near the euro area are small in economic and financial terms (compared with Asian and Latin American countries), it is no great surprise that the euro's share in global foreign exchange reserves is still rather small, although it has risen gradually from roughly 15% to almost 20%. Available evidence suggests that several central banks of the new EU Member States, candidate and potential candidate countries intervene in foreign exchange markets mainly by using the euro as intervention currency.

My final remark in this overview of the facts and figures relates to one specific international use of the euro: in certain countries neighbouring the euro area, the euro is used in *parallel* alongside the national currency, as a means of exchange, unit of account and store of value in people's everyday transactions. In the past, we could only estimate the amount and geographical dispersion of the euro's legacy currencies, notably the Deutsche Mark, in those countries. The cash changeover provided an excellent opportunity to bring out into the daylight the large amounts of Deutsche Mark that were stashed away under mattresses in these countries and that had to be exchanged into euro at the beginning of 2002. Net shipments of euro cash by euro area banks point to an outstanding stock of euro cash in non-euro area countries of at least €46 billion in mid-2004. In addition, euro-denominated deposits in a number of countries neighbouring the euro area increased substantially in the wake of the cash changeover, when households transformed a large part of their euro legacy-currency holdings into euro-denominated deposits in the respective banking systems.

This analysis of developments over the past five years leads us to the following three main conclusions: first, the international role of the euro has increased significantly, though rather gradually; second, it is based on a strong regional focus, notably on the regions near the euro area; and third, it was driven by substantial demand from euro area investors for euro-denominated bonds issued by non-euro area residents.

III.3. The outlook for the international role of the euro

This is where we stand after five years. What are the prospects for the international role of the euro? The internationalisation of a currency is a very gradual process, characterised by considerable inertia. For example, in foreign exchange markets, this inertia is caused by "dynamic economies of scale" and "network externalities". These processes tend to transform an existing situation into a permanent one, as any shift from the use of one currency to another would require a significant shock. A further relevant example in this context is provided by the invoicing of commodities.

The internationalisation of the euro, like that of any other currency, is largely a market-driven process. Whether or not the euro is used outside the euro area for financing, investment or invoicing purposes is a matter of economic agents' preferences. The Eurosystem's policy is to neither support nor hinder the international use of the euro. This should not be interpreted as a policy of "benign neglect", for the ECB can contribute to the euro's internationalisation in various ways: first and foremost, by maintaining price stability in the euro area and safeguarding its internal purchasing power. And we are also promoting financial market integration in Europe and the development of deep, liquid and efficient markets that support the internationalisation of our currency.

Even though the international use of the euro has no specific implications and does not pose any challenges for monetary policy, the ECB, as the issuing central bank, closely analyses developments in this area. As I explained, despite the difficulty in obtaining the necessary data, the ECB continually monitors and analyses the role of the euro in international debt markets, foreign exchange markets, international trade and in third countries, taking account of both its official and private use. The results of this analysis are published regularly and are received with great interest, not only by scholars but also by the EU Finance Ministers and the European Parliament.

IV. Conclusion

Five years after its introduction, the euro is a solid, stable currency in which the markets and the public have confidence. And not just in Europe, but also globally – as the widespread international use of the euro clearly demonstrates. The euro is a success.

When I said at the beginning that I felt privileged to be the first speaker and set the tone, this is what I had in mind. I know that subsequent speakers are likely to address issues which point to some major challenges facing the euro area economy, challenges that must be effectively tackled to improve its performance and growth potential. In confronting those challenges, the accomplishments of the euro in its first five years will undoubtedly prove to be great assets.

Thank you very much for your attention.