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## Building on the Euro's Success

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The title of this chapter was suggested by the organizers of the conference of which this book is the record. With this title, I could be tempted to indulge in describing such important achievements as the smooth introduction of the new currency, the maintenance of price stability, and the growing international role of the euro. Important as they are, however, we should not forget that such achievements are means to an end. The end is to enhance economic prosperity in a stable and safe environment, and to do so both in Europe and worldwide. Indeed, in an increasingly globalized world, we cannot take a domestic perspective only. Spillovers between countries and regions are so powerful and frequent that prosperity and stability can be achieved and preserved domestically only if they are at the same time safeguarded globally.

In this chapter, I describe the euro's success from this broader perspective, and discuss how Europe can help meet the challenges faced by the global economy today. Let me state clearly up front what I see as the euro's three main elements of success from this perspective. First, the European Monetary Union—or, in short, the euro—has brought monetary stability to an economic area that constitutes the world's largest trading partnership and had been for very long an area of instability. Second, it has helped anchor policies in its region, and most particularly in central and eastern Europe, thereby contributing to guiding one of the most profound processes of economic transformation the world has experienced in many decades. And third, the euro is contributing to global adjustment

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patterns with an active and constructive commitment to the principles of the post-Bretton Woods global, multilateral arrangements.

## **The Domestic Dimension**

To start with the domestic dimension, European Monetary Union has put an end to Europe as an area of monetary tensions, exchange rate crises, and macroeconomic imbalances. The euro has turned it into an area of stability. Not only has it eliminated exchange rate disruptions among the participating countries, but it has also established an environment of low long-term interest rates throughout the euro area. Long-term rates have declined by about 5 percentage points from 1994 to the start of the single monetary policy in January 1999. At the same time, interest rate dispersion has virtually disappeared. Given the weight of the euro area in the world economy, this has contributed to global stability in a significant way.

Success was not guaranteed from the outset. Rather, it was dependent on the degree of confidence the euro would inspire among the more than 300 million euro area citizens when they use it as a means of payment, a store of value, and a unit of account. Five years ago, the Eurosystem had still to prove its capability to build and maintain such confidence.

At that time, some skeptical observers predicted that inflation expectations and outcomes in the euro area would rise again once the beneficial effects of the convergence process ebbed. Others argued that the quality of the new currency would correspond only to some average of all legacy currencies, rather than to the benchmark set by the strongest ones. We can say now that both views turned out to be wrong. The Eurosystem has been successful in keeping inflation and inflation expectations stable and anchored to its very demanding definition of price stability.

The euro has also been a central element of the integration process among EU members. For example, it has enhanced competition across borders and acted as a catalyst for structural change.

All these are very important achievements. Yet when discussing economic success, I am acutely aware that Europe is far from meeting one key requirement of that success, namely, combining price stability with healthy rates of growth. This is indeed a crucial issue, to which I shall return when examining the global dimension.

## **The Regional Dimension**

Let us now turn to the second element of success: the anchoring role for policies in central and eastern Europe. The prospect of joining the European Union and eventually the euro area has been crucial in guiding the fundamental economic change implied in the transition from a command

to a market economy. This prospect has also fostered macroeconomic stability in the region.

In May 2004, 75 million people joined the European Union, and the euro will ultimately become their currency. The path toward the full monetary integration of the new entrants is clearly laid out and will be implemented as they progress in convergence. Many of the benefits are already visible now. Trade integration has already fully occurred, and many of the prospective new member states are trading as much with the current EU members as those members are doing among themselves. Financial integration is also highly advanced, through the ownership links between EU commercial banks and the banking systems in central and eastern Europe.

As for nominal convergence, inflation rates five years ago were still at 10 percent in the region and had declined to 2 percent by last year, without economic growth suffering. As a matter of fact, several of the new entrants are closer to meeting the numerical Maastricht criteria today than the current euro area members were five years before the euro. This means that the prospect of euro adoption has already helped anchor policies in this part of the global economy and is entrenching progress in transition, integration, and nominal convergence.

Of course, the impressive progress in *nominal* convergence should not hide the enormous task of *real* convergence. The purchasing power per head in the prospective member states is only about half that in the current European Union. The major challenge is indeed catching up in terms of prosperity. But the conditions are in place for these countries to grow by more than 5 percent a year for many years. This would be in line with the experience of regions and countries such as the south of Germany, the northeast of Italy, and Ireland. The main challenge for new member states will thus be to preserve and strengthen nominal convergence while succeeding in the real catching up.

The anchoring effect of the euro in the region neighboring the euro area goes, however, well beyond the scope of prospective new member states. The European Union has significantly tightened its economic, financial, and institutional links with many countries surrounding it. The European Union's enlargement is the best-known example, but there are also the Stabilization and Association Process with the countries of the western Balkans; the Barcelona Process with Mediterranean countries; and the Partnership and Cooperation Agreements with countries of the Commonwealth of Independent States, notably Russia. Indeed, from an institutional point of view, current developments in Europe represent an expansion of the cooperative framework that has characterized the European integration process since the early 1950s.

The euro is, of course, only part of this whole process, but not a minor one. In terms of *official* use, most of the roughly 50 countries for which the euro is—in various degrees of intensity—an anchor or a reference currency are located in the immediate geographical neighborhood of the euro

area—in particular, the countries of central and eastern Europe, the Mediterranean, and the Balkans. In terms of *private* use, the euro is an important financing currency for borrowers and a major vehicle currency in foreign exchange markets in countries close to the euro area. In addition, a significant use of the euro as a parallel currency can be observed in the European Union's neighboring regions.

## The Global Dimension

Turning now to the global dimension, the euro has well established itself as the second international currency. In some areas, in particular in international financial markets, its importance has grown during the past five years. Financial institutions and nonfinancial corporations, in particular those from the United Kingdom, the United States, and Canada, have taken advantage of the greater size and liquidity provided by the increasingly integrated euro bond market. As a result, the share of the euro in the stock of international debt securities rose from about 20 percent in 1999 to more than 30 percent in 2003. In other areas, the international role of the euro has remained relatively stable. An example is the foreign exchange market, where the share of the euro in foreign exchange transactions today is not significantly bigger than that of the deutsche mark in the past, accounting for about one-quarter.

Beyond this rather specific role, however, what matters most is the contribution the euro provides to global monetary and financial stability. This contribution consists in the euro area's constructive participation in the post-Bretton Woods arrangements, and in its active commitment to multilateral cooperation. It is useful to elaborate on this point, because in this area we are now confronted with a most pressing issue, namely, how to achieve the adjustment of the large global imbalances as smoothly as possible, avoiding—or at least minimizing—negative effects on global economic growth.

What should the euro and the euro area do to meet this challenge? To answer this question, I refer to four key features of the post-Bretton Woods regime. First, no single currency performs the anchoring role for the other major currencies. Second, exchange rates are determined by market forces and ought to be in line with economic fundamentals; as such, their movements are expected to contribute to the adjustment of external imbalances. Third, because exchange rate markets may be very volatile and may produce disorderly movements among the major currencies, occasional public action through verbal or, in some special circumstances, market intervention might be undertaken. Fourth, the appropriate framework for international cooperation is a multilateral one, mainly through the Group of Seven and the IMF.

Let me say that the euro area's policy is fully consistent with these four key features. Exchange rate developments enter into the European Central Bank's (ECB's) monetary policy strategy, together with all pertinent economic variables, to the extent that they have a bearing on its primary objective of price stability. The ECB respects the fact that the exchange rate of the euro is essentially market determined. At the same time, the ECB has—on a very few occasions during the past five years—made its view clear about specific developments in the exchange rate of the euro. For instance, it has recently observed that the current magnitudes of exchange rate swings could create momentum and excessive volatility in financial markets that might be unwarranted on the basis of economic fundamentals.

It is by accepting the logic of the post-Bretton Woods regime that Europe has fully supported the adjustment process during the past two years. It has done so in spite of the fact that Europe is not contributing—in either direction—to the gravity of present global imbalances. As part of this adjustment process, the euro has appreciated against the dollar by about 46 percent since March 2002, with more than one-third of this (17 percent) concentrated between September 2003 and February 2004. Perhaps even more striking, the euro has appreciated by virtually the same percentages on average vis-à-vis the currencies of China, Japan, South Korea, and the other main Asian economies. This is due to the link these currencies have maintained with the dollar. Such an appreciation is striking if one considers how strong competitors these economies already were before depreciating and how large their external surpluses are.

From experience, we know that to bring large external imbalances back on a sustainable path, changes are required both in prices and quantities. The exchange rate alone is not sufficient; growth differentials must also adjust. And here is where lies the main challenge for Europe today: to increase its potential and actual growth. For the world economy not to slow down, it will be necessary, in the years to come, to step up European growth.

During the past decade, real GDP in the euro area grew at the disappointingly low rate of 2 percent a year, whereas in the United States it exceeded 3 percent. I am always struck with admiration when I think that the United States' actual growth exceeded its potential growth for six of the last seven years of the 1990s. Even if one considers that part of the EU-US growth differential is attributable to a difference in demographic trends, the extraordinary performance of the US economy remains.

Not only is *potential* growth relatively low in Europe; the *actual* growth performance is also persistently falling short of that potential. At this moment, prospects for recovery seem to lie ahead, given the establishment of macroeconomic stability and very low interest rates (indeed, the lowest in 50 years). Moreover, important structural rigidities have been dismantled in Europe in recent years, and the integration of 10 new catching-up

economies is an implicit promise for growth. However, there is no room for complacency: Europe still falls short of its aim to become a fully competitive and dynamic economy. Only by significantly stepping up its own growth performance will Europe complete its contribution to overcoming the challenges facing the world economy.

But I think that there is yet another, no less relevant European contribution to the functioning of the global economy. This is to strengthen the multilateral character of international cooperation. To this end, Europe can build on its success in applying multilateralism to its regional integration. A close look at the origins of the current imbalances suggests that they have emerged—at least partly—from a policy environment characterized by a degree of unilateralism.

As we know, the reserve buildup in Asia has become the main source of financing of the US current account deficit. This unprecedented buildup has been motivated to a significant extent by the desire of Asian governments to protect their economy against external shocks and by the pursuit of a growth strategy that was largely export led. The pursuit of such a strategy is understandable, because it combines domestic development with international integration. After all, Europe followed a similar path in the 1950s and 1960s. However, a policy in which the countries peg, or tightly manage, their currencies vis-à-vis the dollar implies that the latter becomes the informal common monetary standard both in the region and in relation to the outside. Actually, although formal efforts at regional economic integration have recently increased in Asia, monetary issues have not yet become a significant part of this process.

For some years, a policy of unilateral dollar pegs in Asia has benefited all parties involved. The United States has been able to finance fiscal and current account deficits in an environment of low interest rates despite a falling dollar. Asian countries have received strong growth impulses, and some have even welcomed the buildup in reserves as a further measure to fight deflationary tendencies. However, one may wonder how long this mutually beneficial outcome will last. Indeed, since mid-2003 there have been increasing calls, particularly from US authorities, for more flexibility in Asia's exchange rate management. This has been advocated with a view of leading to some orderly and progressive appreciation of the currencies of emerging Asia. The Group of Seven statement at Boca Raton in February 2004 points in the same direction.

The adjustment of global imbalances is a delicate process, which has a global and multilateral character even when such imbalances are not evenly distributed across the world. At the same time, we should be aware of the fragility and incompleteness of the system of open trade we have constructed over the years. I know of no country where the constituency of protectionism takes long vacations. Recently, there have been suggestions in some quarters, both in the European Union and the United

States, in favor of protectionist measures to tackle increasing competition by Asian countries.

I mention this to stress that in an increasingly globalized economy, the preservation and strengthening of a satisfactory multilateral framework is crucially important. As a European, I am aware that the move toward exchange rates more in line with underlying fundamentals can be difficult. This is all the more true when exchange rate policies not only bear on trade and financial relations with the anchor country but also on those with important trading partners in the region. But at the same time, and against the background of the European experience, I venture to say that it will be difficult to secure progress in economic and financial integration—both within Asia as well as between Asia and the rest of the world—without addressing at some point the monetary dimension of such cooperation.

## Conclusions

In discussing the euro's success, I have said relatively little about the achievements of introducing a single currency for 12 sovereign nations, the maintenance of price stability in the euro area, and the euro's gradually increasing international role. I have said relatively little about these issues because I regard them as necessary foundations for the euro's success but not as its essence. In my view, the essence lies deeper—in having brought stability to Europe, both in the euro area and its neighboring regions, in contributing to global adjustment through a commitment to exchange rate arrangements fully consistent with the post-Bretton Woods setting, and in reinforcing principles of multilateral cooperation that are applicable at the regional as well as global levels.

It is in these areas that the euro contributes to a more efficient and stable international monetary system, and it is also here that we must continue to work to further improve the functioning of this system—domestically, in fostering sustainable growth in the euro area, and globally, in working toward a framework that accompanies globalization in the real economic sphere with an appropriate framework in the monetary sphere. The positive experience of the euro reminds us that a multilateral framework is the best choice to make.

