The euro's second decade: success continues!

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I want to thank President Richard Fisher for his kind words of introduction and for his wonderful hospitality, here, at the Federal Reserve Bank of Dallas.

In January 1st 1999, eleven member states abandoned their own national currencies and adopted the euro as their single currency. The European Central Bank, one of the most independent central banks ever created, was entrusted with the conduct of the single monetary policy, aiming at delivering price stability over the medium term. Ten years later the euro was the single currency of sixteen member states of the European Union. It covered a geographical area with a population of about 325 million people – about 5 per cent of world population -and producing more than 16% of World GDP. In spite many skeptical comments, after the first decade, the euro has been a success!

At this point a frank and open warning is in order. My professional career, outside University, started a little over twenty years ago. My job was to follow European monetary negotiations. I have been associated with European monetary integration ever since. For example I represented the Portuguese minister of finance in the negotiations that led to the Maastricht Treaty, I was chairman of the Group of Alternates of the Monetary Committee, that prepared the Stability and Growth Pact, I was the first Head of Research at the European Central Bank and, more recently, before returning to the Eurosystem, I was the Head of the Bureau of European Policy Advisers to the President of the European Commission. Clearly with a career around European monetary integration I do not claim the viewpoint of the detached, impartial observer. That is reflected in the title that I have chosen for this address: "The euro's second decade: success continues!" Given that the organizers – Jean Pisani-Ferry, Adam Posen and Mark Wynne – are well aware of my biases I am particularly grateful for this opportunity to

[1] The views expressed are my own and do not necessarily reflect those of the Banco de Portugal or the Eurosystem.

address such a distinguished gathering. The views I will be expressing are my own and do not necessarily reflect those of the central bank of Portugal or the Eurosystem's.

My own biases may be, on reflection, entirely appropriate. In the US the idea of the single currency and the single monetary policy in Europe were received with skepticism. Some extreme US positions have been portrayed by my friend Lars Jonung as echoing an older comment about European integration in general: It´s a bad idea; it won't happen; it will be disaster!

A crucial element to evaluate success of the single monetary policy is to look at inflation expectations. In a 2007 speech on the determinants of inflation and inflation expectations, Chairman Bernanke stated that "The extent to which inflation expectations are anchored has first-order implications for the performance of inflation and the economy more generally". The statement echoes the view from Paul Volcker, who wrote: "I have one lesson indelible in my brain: don't let inflation get ingrained. Once that happens, there is too much agony in stopping the momentum".[2] It is, therefore, very important that reputable monetarist economist Manfred Neumann[3], who was previously skeptical, wrote: "After almost ten years of operation the ECB has reached the status of an international leading central bank that serves the citizens of the euro area well by providing and safeguarding an internationally demanded stable currency". Looking at information from financial markets and from surveys it is fair to say that the European Central Bank has been credible from day one. The ECB has clarified that price stability means keeping inflation below (but close to) two per cent over the medium term. For most of the time inflation has been close to (but not below) two per cent.

The point I want to stress, however, is how well-anchored medium-term inflation expectations have been in the recent past, in spite of very pronounced fluctuations in headline inflation. Specifically, while headline inflation increased sharply up to mid 2008 and fell fast after that, reaching negative territory, inflation expectations varied very little, close to the central bank's definition of price stability. Well-anchored inflation expectations constitute an important contribution to preventing self-fulfilling deflationary spirals that constituted one of the major

[2] The quotes from Bernanke and Volcker are taken from Gaspar, Smets and Vestin, Inflation Expectations, Adaptive Learning and Optimal Monetary Policy, chapter prepared for *The Handbook of Monetary Economics,* edited by Benjamin Friedman and Michael Woodford, forthcoming with Elsevier, North-Holland. The paper provides full references for the quotes.

[3] Manfred Neumann, ECB's Monetary Policy, chapter 7 in Marco Buti et al. (eds.), *The Euro: the First Decade*, forthcoming with Cambridge University Press.

risks, in the context of the Global Crisis. The example provides an illustration of the "first order implications" from well-anchored inflation expectations, for the overall performance of the economy. But the ECB, and the Eurosystem, made important additional contributions to stability in the euro area, in the context of the Global Crisis. For example it avoided, for participating countries, additional disturbances coming from foreign exchange markets. Last but not least, the functioning of the Eurosystem´s operational framework, for monetary policy implementation, subsumes the lender of last resort function, thereby contributing to stability in financial markets[4].

The euro area is a dynamic entity and its process of enlargement is ongoing. After its creation in 1999, the monetary union extended its border on four occasions; first to encompass Greece in 2001 and then to take in four of the new Member States: Slovenia in 2007, Cyprus and Malta in 2008, and Slovakia in 2009. The EU treaties provide a clear institutional path for euro adoption. Each of the twelve Member States of the fifth and sixth enlargement (i.e. those of 2004 and 2007) is expected and is willing to adopt the euro as their national currency. Each of the four enlargements of the euro area so far has been very successful; the changeover from a national currency to EMU was smooth both from a national and EMU perspective. Most likely, the euro area membership will approach or exceed 25 by the end of the second decade, and the monetary union borders will be progressively indistinct from those of the EU.[5]

At the beginning, questions about the euro area included: would the transition from national currencies to the euro proceed without disruption? Would the single monetary policy be perceived as credible? Would the fiscal rules – embodied in the Stability and Growth Pact (SGP) – ensure budgetary discipline? Would the institutional architecture of the euro area prove flexible enough to withstand the pressure of unforeseen change? Would enlargement of the euro area proceed smoothly? Would a monetary union be sustainable in the absence of a political union? Or even, how would the public react to the euro banknotes without national

[4] The classical lender of last resort function, as defined by Bagehot, can be characterized by the following principles: (1) The lender of last resort aims at protecting the integrity of the financial system rather than individual institutions. (2) It supports the central bank's monetary policy objectives. (3) Insolvent institutions should be allowed to fail. (4) Only institutions which are illiquid but solvent should receive lender of last resort assistance. (5) Lending of last resort should be conducted at penalty rates. (6) Lending of last resort should only be granted against good collateral. (7) The conditions ruling lending of last resort should be announced and well-understood in advance of the event of a crisis. The marginal lending facility defines the upper end of the interest rate corridor, for overnight interest rates and satisfies Bagehot's principles. In addition the central bank may provide additional liquidity to the market through open market operations.

[5] Note, however, that the EU is also itself a dynamic entity and may be enlarged again over the next years.

symbols? I think that after the first decade, and with regard to all these questions, the euro has been successful beyond expectations.

I will not elaborate further as this is not what I have been asked to talk about. Adam Posen asked me to reflect on the next decade of the euro area. At this point in time, the first thing that is important to realize is that the Global crisis will have long lasting consequences. For the euro area the main aspect to stress are the clear evidence of strong interdependence and spillover effects; high and rising unemployment; enduring vulnerability in the financial system; high deficits and significant increases in government deficit to GDP ratios and, last but not least, significant cross-country divergences. Moreover, adjustment after the crisis will have to include transformational change associated with demographic trends, globalization and technological change. The crisis has not changed the nature of the challenges associated with these fundamental long term trends. Nevertheless, it does add a ring of urgency to the process of change.

Earlier in my talk I gave a list of questions that were frequently asked at the beginning. Yesterday Mark Wynne asked me if I would welcome Q&A. I said yes! The plan is: I provide the questions and you will contribute the answers. A possible list is:

- Will the ECB manage successfully its exit from its current exceptional stance and continue its impressive record in maintaining price stability over the medium term?
- Will the framework for financial supervision and regulation prove effective? Will the new European Financial Stability Risk Board and the European System of Financial Supervision work well? How will the ECB, in particular, and central banks, in general, adapt to the new systemic risk management framework?
- Will the single currency continue to be an important driver of deeper integration in the single market?
- Can rules and procedures, aiming at fiscal discipline in the euro area, effectively mitigate the deficit bias in government finance and ensure sound public finances in view of the on-going demographic transition and of the need to provide for fiscal space?
- How to protect financial stability, of the euro area as a whole, in the face of turmoil in sovereign debt markets?
- Will further enlargement of the euro area proceed smoothly?

- Will participating Member States be able to adopt the necessary measures in order to facilitate structural adjustment and ensure the transition to a competitive position compatible with sustained growth?
- Will the euro area be able to develop a coherent position in international monetary forums? Will it be able to co-operate, with the US and others (e.g. in the context of the G-20) to better governance at the global level?

The euro area has an economic constitution based on stability. The forces of integration inside the area are very strong. The euro area was extremely successful in its first decade and – I hope and expect – will be very successful in future decades as well. In case the answer to all the above questions is positive it will be fair to say in ten years time that the euro area has (again) been successful beyond expectations.