Mr Noyer summarises the main features of the Eurosystem's monetary policy strategy and discusses the short past and the long future of the euro

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, on the occasion of a conference organised by "le Club des Affaires de Berlin e.V.", Berlin, on 23 February 2000.

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Ladies and Gentlemen,

It is a pleasure and an honour for me to speak here at the Club des Affaires de Berlin today. Since the foundation of the Federal Republic of Germany more than 50 years ago, Berlin has attracted prominent speakers from all over the world praising this city as a symbol for the achievements of Western-type market economies. With the fall of the Berlin wall and the introduction of the euro, integration in Europe has gained a new quality both from an economic and a political perspective. German unification has raised expectations of a wider unification in Europe in the sense of further integration. As Romano Prodi, the President of the European Commission recently declared before the European Parliament: "The opened Brandenburg Gate stands as a powerful symbol of our continent's future."

The birth of the euro as the single currency for eleven Member States of the EU was an important step. Although this was only one year ago, the euro can be seen as a symbol for European achievements. The single currency offers a great opportunity to achieve and maintain price stability in Europe and to create the conditions needed for sustained economic growth. For the euro to become a "success story" as the single currency for around 300 million people, the confidence of the population in the stability of the new currency and in the single monetary policy of the Eurosystem plays a crucial role. The establishment of a "stability culture" throughout the euro area will contribute to the stability of the euro. The foundations of this stability culture are to be found in a broad consensus among Europeans that the maintenance of price stability is of utmost importance. A stability culture also facilitates the achievement of other objectives, such as high employment.

The introduction of the euro marked the culmination of a long period of successful preparatory work, the magnitude of which can hardly be overestimated. As a result of these efforts, the introduction of the euro took place in an environment of price stability that only a few observers would have predicted some years ago. In its short history, the Eurosystem has started to build up credibility and to gain a sound reputation in financial markets for its stability-oriented monetary policy. In the course of 1999, inflation for the euro area remained at a rate consistent with price stability of around 1%. The Eurosystem is determined to conduct the appropriate policy in order to ensure that price stability remains in place.

Let me also mention that, as expected, the transition of the euro area financial markets to the year 2000 went smoothly. This reflects the careful preparation of the banking and financial community and the comprehensive and flexible operational framework of the Eurosystem.

The establishment of Monetary Union marks an outstanding historical achievement. In my remarks I should like to summarise the main features of the Eurosystem's monetary policy strategy and the experience gained with the euro in this first year. By subsequently addressing forthcoming challenges, I should then like to span the bridge towards the future.

A clear and transparent monetary policy strategy

Let me describe our first experience with the monetary policy strategy in the euro area. The Eurosystem has chosen a clear and transparent monetary policy strategy with a quantitative definition of its primary objective of price stability. The chosen stability-oriented monetary policy strategy is forward-looking and medium-term oriented. The Eurosystem has a policy framework which truly reflects the complexity of the economy. It is sufficiently flexible to allow for appropriate responses to specific shocks. It also allows account to be taken of the possibility of regime shifts that could impact on the stability of important economic relationships in the course of time.

Let me briefly recall the main elements of the Eurosystem's strategy. A clear definition for the primary objective to maintain price stability in the euro area contributes to stabilising market expectations. Price stability is defined as an annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. The Eurosystem aims to maintain price stability in line with this definition over the medium term. In order to achieve its overriding objective, the Governing Council has adopted a two-pillar approach.

The *first pillar* assigns a prominent role to money. By announcing a reference value for the growth rate of a broad monetary aggregate, the strategy takes into account that inflation is a monetary phenomenon in the medium term. The reference value exploits the leading indicator properties of the broad aggregate M3, which according to most empirical studies is the most useful guidepost for future price developments in the euro area. The first reference value was set in late 1998 at an annual growth rate for M3 of 4½%. Following a review of the reference value in December 1999, the Governing Council decided to leave the reference value unchanged on the grounds that the underlying assumptions are still valid. Under normal circumstances, significant and sustained deviations of actual monetary developments from this value would signal future risks to price stability. However, the reference value is not an annual target. Rather, it is based on medium-term assumptions and serves as a guide for developments over the medium term. Moreover, the ECB is not committed to ensuring that M3 grows in line with the reference value at a particular point in time.

The *second pillar* of the monetary policy strategy is a broadly based assessment of the outlook for price developments and risks to price stability in the euro area as a whole. This assessment encompasses a wide range of financial market and other economic indicators, including forecasts produced both within and outside the Eurosystem. Within the second pillar, cyclical developments and wages are important indicators for future price developments. In addition, the exchange rate is one of the important determinants of the outlook for price stability. If exchange rate developments pose a threat to price stability in the euro area, this threat will be taken into account together with the information on price developments revealed by all other indicators.

Monetary policy does not react mechanically to developments in a single indicator or forecast. Instead, based on the signals provided by both pillars of the strategy, the Governing Council of the ECB sets the monetary policy instruments of the Eurosystem at the level which best serves the achievement of its primary objective.

Watchers of the ECB have criticised our communication policy for a lack of transparency. Central banks are used to this kind of criticism. More recently this criticism has also been extended to other central banks which follow a strategy of (direct) inflation targeting. However, we should be clear that revealing every aspect of an ongoing discussion is not an objective in itself. Instead, communication should be an element that reinforces the efficiency of monetary policy by making it comprehensible and facilitating its acceptance by economic agents. It is therefore important to judge carefully the contribution which the various elements of communication can make to the fulfilment of the primary objective of monetary policy.

Such considerations apply for example to the issue whether the ECB should publish forecasts for euro area variables. Forecasts represent information which is important for monetary policy decision-making. However, publishing forecasts as a central bank is different from publishing forecasts as an outside institution. It is the objective of the ECB to maintain price stability. Since the objective of the ECB is to achieve this over the medium term, any forecast, which is for example based on constant interest rates, does not take into account that monetary policy takes action in time to ensure price stability. In other words, while forecasts may inform interest rate decisions, there should, in principle, never be any doubt that after the ECB's decision the outlook for price developments should be in line with price stability. In this context, it would then be problematic to send signals into the public debate, which could influence inflation expectations. Furthermore, in the construction of forecasts, behavioural, institutional and structural uncertainties should not be overlooked. Large uncertainties can make forecasting price and other developments in the euro area inevitably difficult.

Forecasts have therefore to be interpreted with great caution and an assessment has to be supplemented by an evaluation of risks and uncertainties underlying the forecast. Therefore, publishing just a single number for the inflation outlook would clearly be misleading. Instead, a careful interpretation of the results is required in order to exploit the signals for monetary policy purposes. Before the ECB publishes any forecasts, it is crucial that we explain carefully the uncertainties surrounding it, the assumptions being made and to what extent then forecasts actually play a role in our decision. Otherwise, publishing forecasts might finally increase uncertainty and even complicate the maintenance of price stability.

Let me point out that the ECB has set high standards in terms of openness, transparency and accountability. As part of its communication policy, the ECB provides the public and other policy makers regularly with timely and detailed information on the Governing Council’s assessment of monetary, financial and economic conditions in the euro area. This assessment reveals forward-looking information of the outlook for price developments as well as the risks to price stability. A statement of the President is released immediately after the first Governing Council meeting each month. This has the advantage of presenting the Council’s assessment of the economic situation almost instantaneously after the meeting. Each month the ECB publishes a bulletin providing additional background information to explain its current assessment of monetary, financial and other economic developments in more detail. Once a year, the ECB releases an annual report on its activities to the European Community institutions.

Gaining first experience

The monetary policy strategy has passed its first tests successfully. In addition to the described elements of the strategy, consistency and transparency of the Eurosystem’s monetary policy decisions were a crucial aspect. This can be best illustrated by discussing the most important factors influencing the interest rate changes decided so far by the Eurosystem.

In the first few months of last year, signs emerged that the extent of the slowdown of economic activity in the euro area might be stronger than had been anticipated. At that point in time price pressures continued to be weak. In this environment it became increasingly clear that the negative effects stemming from the crises in Asia and Russia on growth and employment in the euro area represented a downward risk to future price stability in the euro area. This assessment was also reflected in the downward revisions to the inflation forecasts of international organisations at that time.

A monetary policy reaction to these downward risks to price stability was, however, complicated by the fact that at that time some indicators appeared to point in the opposite direction. In particular, the three-month average of annual growth rates of M3 was slightly above the reference value. Consumer confidence remained comparatively strong despite the economic slowdown. Furthermore, oil prices had been rising since mid-February and the euro had depreciated in effective terms. These two factors were also able to exert upward pressures on prices in the short term.

However, there were several indications that M3 was temporarily being distorted upwards in early 1999 as a result of the changeover to Stage Three of EMU. Thus, in early 1999, it did not appear that M3 growth revealed upside risks to price stability. Moreover, since most of what could be assessed by then was a normalisation and correction of excessive developments in late 1998, the Governing Council did not regard it as appropriate to overemphasise relatively volatile movements in oil prices and exchange rates in the first few months of 1999.

All in all, while in early April the first pillar of the monetary policy of the Eurosystem was not judged as pointing to upward risks to price stability, the second pillar of the strategy was signalling significant downward risks to price stability. This assessment made it necessary for the Governing Council to take action. With a view to maintaining price stability in the euro area over the medium term, the

Governing Council of the ECB thus decided at the beginning of April 1999 to reduce the interest rates on the main refinancing operations by 50 basis points to 2.5%.

At around the beginning of the summer, it appeared that the downward risks to price stability receded. Over the summer, the three-month average of the annual rate of M3 growth increased further and progressively approached a rate of 6%. Overnight deposits and credit to the private sector continued to expand rapidly. A protracted monetary expansion was thus evident. At the same time, the external environment strengthened as the Asian economies stabilised and then started to recover, while concerns for financial crises in other emerging markets receded. In this environment, economic activity in the euro area progressively recovered. In addition, the effective exchange rate of the euro weakened further and oil prices continued to rise. These two factors were gradually feeding through to consumer prices. Therefore, information contained in both pillars provided evidence that the balance of risks to future price stability had been progressively moving upward since the beginning of the summer. The downside risks which were present at the time of the cut in ECB interest rates in April no longer prevailed. On 4 November the Governing Council decided to raise the interest rates on the main refinancing operations by 50 basis points to 3%.

The increase in interest rates at that point in time was aimed at helping to counter the upward pressure on future prices and at contributing to keeping inflation expectations safely below 2%. The interest rate decision was taken in a timely manner so as to avoid the need for stronger measures later. This is consistent with the focus on maintaining price stability and would thus contribute to sustaining non-inflationary economic growth in the euro area over the medium term.

In late 1999 and by 2000 risks to price stability moved again to the upside. Both pillars were indicating increased risks to price stability. Considering the first pillar of the monetary policy strategy, monetary and credit growth continued to signal generous liquidity conditions. Monetary expansion remained high as evidenced by the latest three-month average of annual M3 growth of 6.1% for the period covering October to December 1999. The expansion of credit to the private sector continued to be strong with rates around 10%. These developments were indicative of a continuation of a generous liquidity situation.

As for the second pillar of the monetary policy strategy, the oil price and exchange rate movements observed in late 1999 and January 2000 have added to upward pressure on prices in the euro area. In fact, price and cost increases were larger and more protracted than foreseen earlier and hence indicated renewed upward risks for price stability. The latest price developments for the euro area were reflecting this pattern, given a pick-up in the HICP inflation rate to 1.7% for December 1999. Adding to these risks was the fact that the international environment has been showing continuous signs of improvement and the prospects of a cyclical upswing in the euro area have improved. Indeed, significant improvements in the economic outlook were confirmed by estimates of real GDP growth for the third quarter of 1999 from Eurostat and by available confidence indicators that pointed to a continued solid output growth in the fourth quarter of 1999. Against this background the Governing Council decided to raise ECB interest rates by 25 basis points in February 2000.

The explanations of the decisions to change ECB interest rates in 1999 and in February 2000 show that we do not react mechanistically to individual indicators. Instead, we always interpret the movements and signals in all of the indicators evident in both pillars in conjunction with each other. As outlined and given that we are living in a complex world, this is a more reasonable approach than relying on a simple indicator. Timely and appropriate monetary policy adjustments should ensure that the risks to price stability are kept under control.

The Governing Council's determination to counter threats of inflation should assure wage negotiators that the prospects for price stability remain favourable. In fact, it will be important to ensure that wage settlements themselves do not constitute a threat to price stability in the medium term.

The international role of the euro

Let me turn to the implications the introduction of the euro had for the international capital markets. The euro has become the currency of an economic area which roughly equals the United States in terms of economic size and external trade, and which has the world's second largest capital market. Owing to the fact that a number of the currencies replaced by the euro had played an important international role in the past, the euro inherited this role. After the US dollar, the euro is the second most widely used currency in the world. In parallel with growing investors' confidence and as more EU Member States join the euro area, in particular following an EU enlargement, the international role of the euro will receive further stimulus.

Let me emphasise that the Eurosystem does not actively promote the international role of the euro. Instead a neutral stance has been adopted leaving the determination of the international role to market forces. Maintaining price stability in the euro area helps to gain credibility and the confidence of European citizens in the stability of the euro. This will also contribute to the increased use of the euro outside the euro area.

The international interest in the euro is indeed evident, for example, from international new bond issues. According to information from the Bank for International Settlements, in the first three quarters of 1999, euro-denominated gross international issues of money market instruments, bonds and notes accounted for 38% of total issues, which is only slightly less than the share for the US dollar. By comparison, in the first nine months of 1998 the combined share of the former euro area national currencies and the ECU was only 24% of total gross issuance. Although this strong increase can be partly explained by the postponement of issues from 1998 to 1999, the issues in euro have been growing continuously in the course of 1999 not least owing to positive expectations regarding the future development of the euro area financial markets.

Towards a long future of the euro

Let me now try to look ahead towards the challenges which the ECB and the Eurosystem will have to address in the coming years. The experience with the short past of the euro justifies expectations that we will gradually see further advances towards a broadening of economic and monetary integration in the future. With the establishment of the Eurosystem, solid foundations for a stable currency were laid. Moreover, the principle of central bank independence is anchored in the Treaty.

Let me emphasise that Monetary Union in Europe has a different quality from the German currency union in 1990. German unification led to the introduction of the Deutsche Mark in eastern Germany based on a fixed conversion rate. Monetary Union in Germany was thus achieved at the same time as the political union. However, in Europe the establishment of Monetary Union has preceded the creation of a wider political area. This made it necessary to introduce additional features in the framework of EMU so as to enhance the coordination between monetary and economic policies. For example the establishment of the Stability and Growth Pact facilitates the coordination of fiscal policies among Member States on the basis of a fiscal rule. Sound fiscal policies also facilitate the ECB's task to maintain price stability in the euro area. In this context, the Stability and Growth Pact is a crucial element. Its aim is to encourage the pursuit of disciplined and sustainable fiscal policies by both the participating EU Member States and prospective members.

Safeguarding sound government finances is conducive to achieving sustainable growth and employment creation. The consolidation of public finances, which has made considerable progress in the past few years, has to be continued and, where necessary, strengthened.

There are important conditions to be met in order to achieve sustainable non-inflationary economic growth in the euro area. In particular, decisive measures to address the structural problems in Europe are needed, for example in the area of labour markets. Even, if we see some progress in reducing unemployment in the euro area over recent months, this problem is still pressing. There is no doubt that it needs to be tackled by policies enhancing the flexibility of the euro area labour and goods markets.

In the coming years, the success of EMU demands that the division of policy responsibilities between monetary and government authorities, as set out in the Maastricht Treaty, is followed. This allows the Eurosystem's monetary policy to focus on its primary objective. At the same time economic policies can be directed more efficiently towards structural problems prevailing in the Member States. Such a sharing of tasks is both transparent and conducive to accountability. It enhances the credibility of monetary and economic policies in Europe.

The focus on price stability does not allow the conditioning of monetary policy actions upon the prospective results of fiscal and structural measures. Similarly, monetary policy cannot be conditional on future wage developments promised by the social partners. In both cases the outcome is quite uncertain. The public could falsely interpret such a form of policy coordination as the attempt to negotiate the ECB's monetary policy stance with other policymakers. This might hinder the Eurosystem's prompt response to shocks that threaten the maintenance of price stability. The Eurosystem should always take into account all available information, not just the information on other intended policy actions.

In the future, we will also see the accession of a number of new Member States to the European Union and eventually to the euro area. It is clear that the envisaged extension of the EU to include new members and, ultimately, the enlargement of the euro area represent important challenges both for Member States and for the Eurosystem. Any enlargement of the euro area is subject to the strict application of the convergence criteria, and not automatic. I should like to recall that the Maastricht Treaty provides for a clear and transparent procedure, which lays down the conditions for EU Member States wishing to join the euro area. This should ensure that Member States provide evidence of sufficient economic convergence with the euro area before adopting the euro.

In this context it is useful to explain the rationale behind the convergence criteria. Their main purpose is to ensure that only those Member States which have economic conditions that are conducive to the maintenance of price stability shall be participants. This is important for the credibility and sustainability of EMU. It makes the case for a strict application of the criteria. As the convergence criteria constitute a coherent and integrated package, they must be all satisfied at the same time. Current data represent the basis for an assessment. An application shall be carried out in a consistent, transparent and simple manner. This implies that a convergence assessment shall also take into account the experience gained in the run-up to Stage Three.

Compliance with the convergence criteria on a sustained basis is essential. This can be best explained for the example of fiscal policies. Looking back, many accession countries have accumulated high or very high levels of public sector debt. This was often the result of economic shocks, distributional or intergenerational problems as well as regional divergences. An unduly high stock of debt typically steers debt-service payments for both current and future budgets until debt levels are substantially reduced.

Exchange rate stability is also a measure of overall convergence, given that exchange rate movements typically reflect, in addition to market expectations, relative movements of economic variables. In this regard, participation in ERM II fosters convergence for prospective euro area members.

The introduction of the euro in other countries will require more than only compliance with the convergence criteria. In particular, further preparatory work in various areas is required. For example, new members have to ensure that the harmonised framework in which the single monetary policy operates is fully in place prior to their participation in the euro area. Statistics need further adaptation so as to comply with the Eurosystem's reporting requirements. Some changes in national legislation are needed to formally lay the foundations for the introduction of the euro. Finally, all procedures that involve the Eurosystem and the prospective member country will have to pass a number of real-time tests in order to demonstrate that the infrastructure is operational.

Conclusions

In summary, looking at the current evidence on the outlook for price stability, the first year of operation of the ECB has been successful. The monetary policy strategy of the Eurosystem has proved to be a valuable tool both in supporting monetary policy decisions and in explaining these decisions to the general public in a transparent manner. The ECB does its utmost to maintain price stability in the euro area in a forward-looking manner and with a medium-term orientation. The Governing Council of the ECB vigilantly monitors the signals provided by the two pillars of the ECB's strategy. Stable prices are the best contribution monetary policy can make to sustained economic growth in the euro area. Maintaining price stability in the euro area will contribute to the credibility of the single monetary policy and to the stability of the single currency. It will pave the way for the long future of the euro.