# Willem F Duisenberg: The euro and the single monetary policy

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the 10th anniversary of the Amsterdam Institute of Finance, Amsterdam, 10 November 2000.

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Ladies and gentlemen,

It is a great pleasure for me to be invited to the 10th anniversary of the Amsterdam Institute of Finance. I wish to express my warmest thanks to the organisers for their invitation. This Institute is rightly famous for providing top-level courses in finance. I think that such a mission is indeed of great relevance today, as financial instruments and techniques are constantly evolving, and dynamic economies require professionals to update and obtain further qualifications throughout their professional lives.

Now, I should like to talk to you about the first two years of experience with the euro and the single monetary policy.

The new monetary regime introduced in January 1999 with the start of European Economic and Monetary Union has proved to be a success in many respects. The operational framework through which the Eurosystem provides liquidity to banks has functioned very well. The ECB's monetary policy strategy has been firmly established, widely explained and is being increasingly understood. The ECB has taken and shall continue to take the necessary decisions to ensure the maintenance of price stability over the medium term. Moreover, the introduction of the euro has acted as a catalyst for restructuring and enhancing competition in Europe. The euro is one of the reasons behind the current pace of economic growth on our continent. Finally, capital markets in Europe have clearly benefited from the establishment of Monetary Union.

Allow me to elaborate further on these issues. The single monetary policy relies on an efficient operational framework, which has been implemented without major difficulties. It has proved to function very smoothly. It has, indeed, managed to clearly signal the monetary policy stance, by steering short-term market interest rates and by providing liquidity to the banking system in an efficient manner. A key element of the functioning of the operational framework has been the TARGET payment system which interlinks the 15 national real-time gross settlement systems and the ECB payment mechanism by providing a uniform platform for the processing of cross-border payments in real time. This is a great technical achievement which has made it possible to create a single interbank market interest rate across the euro area. In September 2000 70% of the value of payment instructions/orders/transactions through gross settlement systems in Europe were processed through TARGET.

Let me now turn to the ECB's monetary policy strategy. A close understanding of the framework of our analysis is indispensable in order to fully grasp the policy pursued by the ECB.

The first element of the ECB's monetary policy strategy is the published definition of price stability. Price stability has been defined as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". The ECB has also stated that price stability is to be maintained over the medium term. The definition is intended to securely anchor inflation expectations. Moreover, it provides a clear yardstick against which the ECB's monetary policy can be held accountable for the achievement of its primary objective.

In order to take appropriate decisions with regard to this objective, the ECB monitors a broad set of indicators. First, a prominent role has been assigned to money as the so-called first pillar of the strategy. The assignment of such a prominent role to money is justified by the available econometric evidence. This evidence suggests the existence of a stable relationship in the euro area between the broad monetary aggregate M3, the price level and a small number of other euro area-wide macroeconomic variables. The important role assigned to money has been signalled by the announcement of a reference value of 4½% for the annual growth rate of M3. The first pillar consists not only of a detailed analysis of deviations of M3 growth from the reference value for the information that they contain about the outlook for price stability, but it also embodies a thorough analysis of monetary developments, including careful monitoring of the components and counterparts of M3.

In addition to a thorough analysis of monetary developments, a comprehensive assessment of a wide range of other economic and financial indicators constitutes a further basis for monetary policy. This assessment encompasses an analysis of, inter alia, cost and price indices, the exchange rate, real economic indicators, and financial markets indicators. In brief, the role of this second pillar is to provide information about the prevailing economic situation and on the nature and magnitude of risks to price stability, which are not made apparent from an analysis of the monetary aggregates in a complete or timely way.

Some commentators have regarded this strategy, based on the assessment of two sets of indicators, as unclear and overly complex. I have two responses to such criticism.

First, new methods and new strategies are not always fully understood from the outset. The learning and familiarisation process can take some time.

Second, I would stress that the two-pillar structure of the ECB's strategy has been adopted for a good reason. Both pillars have well-defined, important and complementary roles. The first pillar consists of approaches to the price determination process which assign a prominent role to money. The second pillar comprises analytical frameworks which focus mainly on real economic variables. Both approaches are valid and can be useful to analyse different aspects of the economic environment in a manner which assists monetary policy decisions.

This broader approach, prompted by the adoption of the two-pillar structure, is particularly proficient in coping with the uncertainties inherent in modern and complex economies. We should recall that these uncertainties may have been compounded by the regime shift associated with the transition to Stage Three of Economic and Monetary Union. The changeover to the single currency may have altered the way expectations are formed in the euro area. It may thus have changed the effects of monetary policy on financial behaviour, consumption, investment and wage bargaining. Or, to summarise, it may have changed the very nature of the monetary transmission mechanism in the euro area. In such an uncertain environment, monetary policy analysts must use a "full-information approach" and carefully cross-check the signals sent from different types of indicators.

Moving to more general issues associated with the introduction of the euro, there is no doubt that this regime shift is acting as a powerful catalyst for economic growth and restructuring in Europe. Several forces are at work. The introduction of the euro combined with the Single Market has increased the "economic" size of the market. Price transparency has significantly improved both across countries and over time. The macroeconomic horizon of investors has been, so to speak, "cleared" by the principle of price stability and the rules of fiscal discipline. Moreover, the single currency provides an impetus for the development and the integration of financial markets in Europe. This in turn will contribute to a more efficient allocation of savings across Europe.

The development and the integration of capital markets in Europe have been fostered for some time now by financial liberalisation, globalisation and technological innovation. The introduction of the euro is giving this trend a significant boost in Europe. The single currency has removed the exchange rate risk barriers between the countries of the euro area; it is facilitating the standardisation of debt instruments and widening the range of investment opportunities. Corporate bond issuance has increased significantly since the introduction of the euro. There are indications that the focus of issuers is shifting in some respects from country-specific to sector-specific risk assessment.

In the banking sector too, the changeover to the single currency seems to have intensified the trend towards consolidation. Although most mergers have been domestic, they have often been instigated and influenced by euro area-wide market developments and the integration of financial markets following the introduction of the euro. Moreover, there is no doubt that the introduction of the euro has encouraged the internationalisation of banking activities. In particular, the rapid integration of the wholesale banking and capital markets, as well as large-value payment systems, has already created closer links between banks at the euro area level.

Overall, these new economic and financial conditions in Europe are creating new investment opportunities, encouraging industrial restructuring and promoting sound competition between economic agents in a new, enlarged market. For sure, the beneficial effects of this new environment on economic structures will only be felt gradually, but there is no doubt that these effects are deep and lasting.

Meanwhile, other economic policies are needed to accompany this restructuring process. This is not to deny that important progress has already been made. Over recent years, wage settlements have been relatively moderate, public finances have improved, deregulation and liberalisation have been initiated in a number of sectors, and there are signs that labour markets are gradually becoming less rigid. Employment grew by 1.8% in 1999 and by over 2% in the first half of 2000, and since the start of Monetary Union, the unemployment rate in the euro area has fallen by 1.5 percentage points.

However, further efforts are required in order to create the best conditions for turning the current upswing in economic activity into a period of sustained growth in an environment of price stability.

With regard to fiscal policies, the overriding objective for governments should be to shelter their budgets not only from normal cyclical fluctuations, but also from unexpected shortfalls in revenues and interest rate increases. In the current favourable economic conditions, it is crucial that any loosening of fiscal policy be avoided and that further progress along the path towards fiscal consolidation is made. In parallel, governments' budgetary policies also urgently need to address longer-term issues, such as the structural reform of social transfer systems.

Significant reductions in unemployment can only be reached through resolute measures to improve the functioning of labour and product markets. The successful experience in some countries of the euro area has shown that such reforms can rapidly provide important benefits for the economy and for society.

Finally, looking at the process of regulatory reform, although a good deal of deregulation and liberalisation of previously sheltered sectors has taken place, there is still plenty of scope for further measures to increase the level of competition and stimulate entrepreneurial initiative.

Let me now shift the focus from structural to more conjunctural issues and briefly discuss the current economic situation. The first message I should like to convey is that there is good reason to remain confident that strong growth will be sustained in the euro area. Euro area real GDP has been growing at an annualised rate of around 3½% for four consecutive quarters, including the second quarter of 2000. Some monthly indicators, which extend into or cover the third quarter of this year, point to some moderation of these high growth rates. In particular, the pace of growth in industrial production appears to have declined somewhat and some survey data showed signs of moderation. At the same time, however, confidence remains high, underpinned by positive factors such as high employment growth. The extended period of high and rising oil prices has certainly increased the uncertainty surrounding the sustainability of recent growth trends in the world economy. However, by contrast with previous periods of strong and prolonged increases in oil prices, the world economy is now less dependent on oil and inflationary pressures are still being contained. This should help to ensure that the impact of high oil prices on growth remains moderate over the medium term. All in all, the outlook is for the continuation of robust growth in the foreseeable future.

Turning to monetary developments, M3 growth has been deviating from the reference value of 4½% since the beginning of 1999. The three-month average of the annual growth rates of M3 covering the period from July to September stood at 5.4%. Over recent months, however, a moderation in M3 dynamics has taken place, as is visible in shorter-term growth rates. For example, the seasonally adjusted and annualised growth rate of M3 stood at 3.6% in September.

At the same time, the recent increase in the growth rate of loans to the private sector should not be overrated. This was considerably influenced by the financing of the payments for UMTS licences by telecommunication companies. This does not imply high risks to price stability in the medium term as long as the proceeds are used, as expected, to redeem government debt.

In sum, recent developments seem to indicate that, following the series of interest rate increases by the ECB, monetary developments are currently settling down at a more moderate pace of growth.

As for the developments in consumer prices in the euro area, annual HICP inflation rose to 2.8% in September, compared with 2.3% in August. This increase mainly resulted from the acceleration in energy prices. A contribution was also provided by the higher year-on-year change in prices of non-energy industrial goods in the HICP to 0.8%, from 0.6% in August 2000. This, in combination with the slight increase in the annual rate of change in processed food prices, led the rate of annual HICP inflation excluding energy goods to increase to 1.6% in September 2000, from 1.5% in August.

Owing to developments in energy prices and the decline thus far in the euro, consumer price inflation may remain above 2% for longer than was expected some months ago. It is important to recognise that these are temporary price increases resulting from external factors which monetary policy cannot counteract. The ECB, like all other central banks, is not able to influence consumer price inflation in the short term owing to the time-lags of monetary policy. Moreover, such first-round effects do not infringe upon the ECB's objective of price stability, since the latter is to be fulfilled in the medium term. In order to ensure the maintenance of price stability precisely over the medium term, it is, however, crucial that longer-term inflation expectations of economic agents do not increase. In this respect, the past decisions to increase ECB rates should have contributed to maintaining confidence in price stability over the medium term.

This confidence should also continue to guide the wage formation process in the euro area. At the current juncture, it is of paramount importance to avoid second-round effects of the increase in oil prices materialising. I am confident that a protracted period of robust economic growth and price stability lies ahead, provided that all policy areas fulfil their respective tasks.