Otmar Issing: The euro - a stable currency for Europe

Speech by Professor Otmar Issing, Member of the Executive Board of the European Central Bank, at Euromoney Institutional Investor Plc, London, 21 February 2001.

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Introduction

Slightly more than two years ago the European Central Bank (ECB) assumed responsibility for the second largest economic area in the world after the United States. The euro is now the currency for 300 million people. The transfer of monetary policy competence from 11 national central banks, many of them characterised by a long history and impressive monetary policy results, was met with a great deal of scepticism. All the more so, because the asymmetry between a self-contained central bank and - in the meantime 12 - national governments brought with it an historically unique situation.

The single monetary policy has not experienced any significant accident so far in its short life: the transition to the single currency has been quite smooth and the Governing Council of the ECB was successful in fulfilling its mandate, namely in maintaining price stability in the euro area over the medium term. Clearly, we are not satisfied with HICP inflation above 2 %, as we have seen since the middle of last year. However, we have announced before we started to conduct our monetary policy that the ECB could not precisely control inflation in the short-term and would not try to as, for example, in the case of an oil price shock. But we have good reasons to expect that, if nothing comparable happens again, HICP inflation in the euro area will fall back to below 2% in the course of this year.

You may ask why I am so confident about this. There are three main reasons. First, the institutional set-up on which the ECB and the euro have been built is very sound. Second, the Governing Council of the ECB managed to set up an efficient framework both as regards the monetary policy strategy as well as monetary policy instruments. Finally, monetary policy in the last two years has rightly been perceived by most observers as having been appropriate to maintain price stability in the medium term. All this is reflected in a high degree of credibility of the ECB, as evidenced by low inflation expectations.

The institutional design

Let me start with the institutional design. The Treaty establishing the European Community - which I will refer to as the "Treaty" - and the mandate of the ECB provide a sound basis both for an effective monetary policy and for the establishment and development of a good reputation and a high degree of credibility for the ECB.

I will focus my attention on four aspects of institutional design which are of the utmost importance for the ECB's reputation and credibility: (1) its mandate; (2) its independence from political interference; (3) its transparency; and (4) provisions that contribute to fiscal discipline.

First, the Treaty establishes a clear hierarchy of objectives for the single monetary policy, giving overriding priority to the maintenance of price stability in the euro area. This reflects the fact that the best contribution that the ECB can make to long run sustained economic growth, employment creation and raising standards of living, is maintaining price stability. The clear priority given to the price stability objective also highlights the fact that the ECB itself does not have either the means or the responsibility for ensuring a high level of employment and real growth, beyond the positive impact of price stability just mentioned. Such a clear allocation of task and objective to different policy-makers ensures efficiency, transparency and accountability.

Second, the Treaty has made the ECB one of the most independent central banks in the world. In this way, political pressures can be avoided and European citizens can be assured that a long-term euro-area wide perspective will be taken by the central bank in pursuing its mandate of maintaining price stability.

Third, the Treaty recognises that the assignment of an important policy responsibility to an independent institution has to be accompanied by transparent and accountable policy design and implementation. Transparency and the accountability of the central bank add to its credibility by imposing discipline on policy-makers. For these reasons, the ECB went significantly beyond the statutory requirements regarding transparency.

Finally, let me emphasise that the Treaty, reinforced by the Stability and Growth Pact, contains important provisions to facilitate the co-ordination of economic policies and ensure sound public finances. The EU countries must regard their economic policies as a matter of common concern. The ECOFIN Council is required to formulate broad guidelines for the economic policies of the Member States and to monitor economic developments within a multilateral surveillance framework. EU governments are also subject to a common code of conduct in fiscal matters, in particular imposing limits on government deficits, as laid down in the Treaty. The Stability and Growth Pact, together with the "no-bail-out clause" and other Treaty provisions, contributes to maintaining fiscal policy discipline.

In fact, fiscal discipline makes it easier for the central bank to maintain price stability and thus indirectly contributes to keeping inflation expectations low.

To summarise, the institutional design of Economic and Monetary Union directly addresses the main problems that a new central bank may face in establishing its credibility: overriding priority is given to maintaining price stability, central bank independence is assured and various provisions go a long way towards ensuring sound public finances. History has taught us that in these institutional features we have laid the foundations of a safe currency.

Setting up a new central bank

Let me now make a few remarks about the experience we have gained in the first two and a half years of setting up a new central bank, both in general terms and in particular with regard to the instruments and monetary policy strategy.

It came, I suppose, as a surprise to those who had been very sceptical about the euro that the birth of the new currency proceeded as smoothly as anyone could have hoped for. Indeed, it was a resounding success. The process of the changeover to the euro was virtually free of technical faults. Almost overnight a unified money market was created, which - notwithstanding a formidable transactions overload - functioned from the very start without any major complications. Short-term interest rate volatility remained well contained, and the main refinancing operations, along with the standing facilities and the reserve requirement system with its averaging provisions, have since guaranteed money market developments closely in line with the ECB's intentions.

The operational framework of the ECB is very market oriented, i.e. it relies on tender procedures, leaving the initiative to banks, and lets automatic stabilisers, through the averaging provision in the reserve requirements system, work. While the ECB sets the framework and the rules, it is up to banks to best exploit the incentives set under this framework.

On this issue, let me add a few remarks on the increase in money market rates which has occurred over the past few days. These developments have occurred following the low amount of bids submitted in the main refinancing operation of 13 February. The recent increase in money market rates should not be seen as reflecting a change in the stance of monetary policy, which continues to be signalled by the minimum bid rate.

Also the monetary policy strategy of the ECB has proven successful from the start. The recognition that monetary policy will always have to cope with a changing and imperfectly known world has been a key consideration in the design of the ECB's monetary policy strategy. In addition, we had to bear in mind the fact that the mere establishment of the ECB as a totally new institution marked a historical discontinuity, with potentially profound implications for economic behaviour and measured structural relationships.

In these circumstances, the Governing Council chose to equip itself with an internally consistent and at the same time comprehensive and appropriately flexible approach to policy analysis. It was decided that the best way we could serve the lasting objective of guaranteeing a stable measure of value in a non-discretionary manner was to adopt a robust analytical framework well-suited to informing policy-makers in a changing world. Developing and refining this framework was our main challenge.

This tension was resolved - and in my view this is the optimal solution - by announcing a quantitative definition of price stability and by adopting an encompassing approach to analysing and assessing information relevant to detect risks to price stability.

Defining price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices of below 2%", along with the emphasis on the medium term, was designed to enhance clarity, to anchor expectations and to provide a yardstick against which the new independent institution could be held accountable.

Likewise, the eclectic but systematic approach to the processing of information relevant for assessing risks to price stability, which we call our two-pillar strategy of monetary policy, was intended to guarantee that no piece of evidence relevant to policy decision-making would be excluded from the Governing Council's information set. The prominent role assigned to money, as the first pillar of our strategy, ensures that monetary developments are always part of the picture, and receive the attention that they deserve, given the monetary nature of inflation beyond the immediate horizon. In parallel, the second pillar of the strategy ensures that other forms of analysis, such as the investigation of the interplay between supply and demand and cost-push dynamics, are also incorporated into the policy process. Together, the two pillars ensure that information and analysis produced on the basis of one methodological perspective are always cross-checked against information and analysis produced on the basis of the other.

Analysis under the two pillars provides the Governing Council with all crucial information regarding the nature of the shocks within the euro area economy and the resulting risks to price stability. The complementing viewpoints of the two pillars have served us well as a comprehensive framework for analysis in the past two years. The strategy has provided the basis for a thorough and timely explanation of monetary policy decisions to the general public.

The current situation

Since November 1999, the Governing Council raised the main ECB interest rates by a total of 225 basis points in reaction to a perspective of upward risks to price stability. These rises have been appropriate. Recent developments point towards increasingly balanced risks to price stability in the medium term. However, the analysis of the information relating to the two pillars of the monetary policy strategy showed that there are still factors which might pose upward risks to price stability and as such will need to continue to be closely monitored.

Starting with the first pillar, monetary and credit growth have slowed down in the course of 2000. The growth of M3 has gradually approached the reference value of 4 1/2% confirming that the risks to price stability stemming from the monetary side have become more balanced in comparison to the situation in early 2000. In fact, the short term dynamics of M3 growth in the second half of 2000 were clearly weaker than in the first half of 2000. This will become visible in the annual growth rate of M3 in the coming months which will be affected downwards by base effects resulting from the strong growth of M3 in the first quarter of 2000.

Turning to the second pillar, several developments have recently changed somewhat the outlook for the euro area. Most notably, the slowdown in the US economy and recent developments in Japan have increased the uncertainty surrounding the prospects for world growth. It is now clear that the international outlook is no longer as positive as it has been for almost two years. World real GDP growth, which in 2000 posted its strongest performance for many years, may moderate in 2001, but is expected to remain solid.

However, whereas the euro area is not immune to external developments, it is a relatively closed economy. While the more moderate prospects for world growth might end up being associated with some further slowdown in economic activity in the euro area, the dynamics of domestic demand suggest that, overall, the outlook for sustained euro area growth remains positive. This notwithstanding, real GDP growth in 2001 might turn out somewhat lower than expected earlier. However, all in all, realistic optimism is justified.

Turning to consumer price developments, the euro area has seen HICP inflation above 2% for some months now. This was mainly due to the unexpected increases in oil prices and the depreciation of the euro. In December 2000 the annual rate of increase in the HICP declined to 2.6%, from 2.9% in November. It is expected that this trend continues in this year although it may take some time for HICP inflation to fall again below 2%. The moderation in oil prices and the appreciation of the euro exchange rate would, if sustained, contribute to a faster decline in overall HICP inflation over the course of this year.

The evolution of external inflation forecasts and of inflation expectations as derived from the analysis of long-term interest rates is reassuring. It suggests that financial markets and economists expect price developments in the medium to long term to be in line with the ECB's definition of price stability.

In spite of the assessment that the risks to price stability in the medium term are now more balanced, there are still factors posing upside risks which require continued attention. One risk is related to the evolution of wages in the period ahead. It is important that wage moderation continues. This should be facilitated by the decline in consumer price inflation which is expected to occur over the coming months. However, the increase in some labour cost indicators in 2000 warrants close scrutiny. A second important factor will be fiscal policy in the euro area. The relaxation of consolidation efforts at this juncture will lead to an undesirable pro-cyclical impact. In order not to threaten the progress in fiscal consolidation, the reduction in the tax burden has to be accompanied by a structural reduction of expenditure.

When evaluating the current situation, I would like to emphasise the obvious, namely that the monetary policy decisions of the ECB are based on the assessment formulated under both pillars of the monetary policy strategy of the ECB and nothing else. The outcome of this assessment is not least reflected in the level of the minimum bid rate on the main refinancing operations. This assessment which is transmitted to the public by the ECB's well-known instruments of communication, and not short-term oriented expectations in financial markets on decisions in the next meeting of the Governing Council, is decisive for the monetary policy stance of the ECB.

Challenges for the euro area

In the context of the recent US slowdown, the following question is often raised: Who might take responsibility over from the United States for "global growth"? I would contend that this question is misleading from the outset. Indeed, the US economic policy has, in my view, always been conducted, and rightly so, with a clear focus on domestic objectives. It is important to note in this regard that the periods of success of the US economic policy from a domestic point of view, i.e. the periods of sustainable non-inflationary growth in the US, have actually coincided with the periods when significant contributions to both growth and stability in the whole world were made by the US.

In principle, the same logic should also hold for the euro area. The euro area is the second largest economic area in the world. Therefore economic developments in the euro area are significant for developments and prospects elsewhere. The mandate of the ECB clearly states that price stability in the euro area is its primary objective. Price stability is indeed a key element of an overall environment leading to sustained growth at domestic level.

In such a context, the best contribution which a large economy as the euro area can provide to support sustainable non-inflationary growth in the world economy is to pursue policies maintaining price stability "at home". This is the only reasonable allocation of responsibilities across world policy-makers. Anything else risks blurring responsibilities and diluting accountability. This, in turn, would distort incentives in a perverse way.

It goes without saying that exchange of information and views, for instance in the context of international fora, may in such a context further help the policy-makers of large economies assume their global responsibilities by providing them with a better understanding of the economic environment.

Notwithstanding the clearly positive outlook for the euro area, a lot has still to be done. While monetary policy will have to remain focused on its commitment to maintain price stability -thereby providing a credible anchor for expectations, the challenge for the euro area will be to best exploit and enlarge its growth potential in the coming years.

Structural reforms have taken place but are far from being satisfactory in most countries. Their implementation is of crucial importance to foster the supply of labour and capital and the innovation and diffusion of new technologies and production methods. More flexibility in labour markets and reforms aiming to encourage labour force participation are necessary to offset the low growth in the working age population. Fostering a knowledge-driven economy, removing barriers to investment and creating the institutional structures needed for a rapid and efficient adoption of new technologies, will strengthen the process of capital accumulation. The ongoing current regulatory reform process will create the conditions to enhance competition and is expected to have important economic benefits. Overall, sound economic policies designed to avoid the appearance of economic imbalances and structural reforms will allow the euro area to better exploit its growth potential, thereby also contributing to growth and economic stability worldwide.

Conclusion

To conclude, let me recall what I said at the beginning of my address. While I am not satisfied with HICP inflation of above 2% as we have at present, price stability will be maintained over the medium term. What I regard as most important is the fact that medium-term inflation expectations are still in line with price stability and, in my view, rightly so. We are convinced that we are well equipped to pursue a stability-oriented monetary policy and thus gain the trust of the public. The euro has proven to be a stable currency for Europe and the world economy, and the best contribution the ECB can do to sustain this achievement is to maintain price stability in the euro area.