

Willem F Duisenberg: What exactly is the responsibility of central banks of large economic areas in the current slowdown of the world economy?

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the International Monetary Conference, Singapore, 4 June 2001.

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The topic of the introduction I have been invited to provide at the Central Bankers' panel is both challenging and welcome. The challenge is to answer a question that has been hovering around in recent months: should the euro area assume the role of a "global growth engine" in the current slowdown of the world economy? The opportunity to address this issue directly is welcome, as it allows me to elaborate on the role the European Central Bank (ECB) must play in this field. In doing so, however, I shall start first by briefly recalling the objective of the monetary policy of the ECB, which provides an essential background to the analysis of the responsibility and the challenges the ECB faces with respect to the current slowdown of the world economy.

The primary objective of the ECB, as the Treaty of the European Union defines it, is to maintain price stability in the euro area. The Governing Council of the ECB has defined price stability as "*year-on-year increases in the HICP for the euro area of below 2%*". Furthermore, it was made clear from the outset that price stability should be maintained over the medium term. By unambiguously assigning the primary objective of price stability to an independent central bank, the Treaty recognises that focusing monetary policy on the maintenance of price stability in the euro area ensures that monetary policy will make the best possible contribution to improving economic prospects.

This view is rooted in the fact, supported by decades of practical experience and empirical evidence, that the benefits of price stability for growth are substantial. Without putting forward all the arguments, allow me to highlight, in particular, that the maintenance of price stability helps to allocate resources efficiently both across uses and across time. Inflation causes economic agents to confuse transitory with permanent price changes, and therefore distorts their decision-making process. In evaluating investment opportunities, firms need to have confidence in the signals conveyed by relative price changes, and to discriminate between relative price adjustments and general changes in the overall price level. This process is facilitated in a situation of overall price stability. Price stability therefore improves the transparency of the relative price mechanism and can promote an adequate environment to increasing the growth potential of the euro area economy. Moreover, as experience has shown, stable prices minimise the inflation risk premium, thereby lowering long-term interest rates and helping to stimulate investment and growth.

In order to maintain price stability, the ECB has designed a monetary policy strategy wherein risks to price stability are assessed on the basis of two pillars. The first pillar assigns a prominent role to monetary developments. The second pillar is a broadly based assessment of a wide range of other economic and financial indicators. This all-encompassing and systematic approach guarantees that the Governing Council of the ECB takes into consideration all relevant pieces of information when assessing the outlook for price stability in the medium term.

All this shows clearly that the ECB needs to focus on the euro area when conducting its monetary policy. Focusing on domestic objectives is, in fact, the mandate of all major central banks in the world, and rightly so. I strongly believe that the best contribution that the euro area can make to world economic growth is to ensure macroeconomic stability "at home" by pursuing policies which lead to sustainable non-inflationary growth in the euro area. Given the size of the economy of the euro area, a stability-oriented policy will help to create a favourable environment conducive to non-inflationary growth at the global level. The mandate of the ECB is fully consistent with this principle. This is the only reasonable allocation of responsibilities among the large economies in the world. Anything else risks blurring such responsibilities and diluting accountability, which would in turn distort incentives in a perverse way.

This notwithstanding, the euro area is not, of course, economically speaking, an island and global developments do affect the euro area economy. Hence, let me also stress that one of the requirements of a globalised world is a frequent exchange of information and views among policy-makers. The ECB currently participates in the meetings of international organisations, such as the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the Bank for International Settlements (BIS), and different fora, such as the G7. Such

exchanges are important, among other things, to better understand economic developments and to fully analyse the spillover effects in the economy arising from different policies.

The ECB is not in a position to fine tune economic activity in the euro area, as it does not have the instruments to do so. Any attempt to do so would prove counterproductive, leading to an inefficient medium-term outcome characterised by higher inflation and lower growth. Two main factors support this view. First, economic developments are surrounded by a great deal of uncertainty. This uncertainty affects the analysis of both the current state of the economy and its future course. And second, monetary policy operates with relatively long lags, having very little effect on the economy in the short run. Past experience has shown that attempts to fine-tune the economy might place in jeopardy the commitment to maintain price stability in the medium term, as is essential for a well-functioning economy. Once inflation exists and inflation expectations prevail in the economy, the economic costs of the subsequent necessary stabilisation far exceed whichever temporary benefits might have been previously obtained.

Therefore, the ECB needs to remain focused on the maintenance of price stability in the medium term. The ECB pursues this objective in a consistent and forward-looking manner, ensuring the confidence of all policy-makers, both within and outside the euro area.

Experience so far suggests that the ECB has been able to keep inflationary expectations at a low level. Although current HICP figures in the euro area are adversely affected by energy and food prices, the current outlook is compatible with the maintenance of price stability in the medium term.

This view is supported by the analysis of bond yields. It is comforting to see that market participants expect medium-term price developments to remain in line with the ECB's definition of price stability. Currently available forecasts give rise to the expectation that inflation will again fall below 2% in 2002. Hence, we appear to be on the right track. However, we must not ignore existing risks to price stability. The Governing Council of the ECB therefore always stresses that it is vigilant and will take into account all new information that might affect the outlook for price stability in the medium term.

Let me now conclude by recalling that, while the ECB cannot be held accountable for growth in the euro area, interest rates in the euro area have been relatively low, and cannot, by any means, be considered to be an obstacle to growth. Currently, although uncertainty remains high, the general expectation is that growth in the euro area will remain at, or slightly above, trend potential growth in the period ahead.

Having said that, the ECB would welcome an increase of the already substantial contribution of the euro area to global economic growth. However, this should be achieved in a lasting way, by increasing the growth potential of the euro area. The growth potential of an economy, however, is determined by technological and structural factors. Raising its growth potential is an important challenge that the euro area faces, achievement of which would spread its benefits throughout the world.

While some reforms have already taken place, additional efforts are needed. Ongoing comprehensive structural reforms of the labour and product markets remain essential in order to improve the functioning of markets in the euro area. Responsibility for these reforms lies with the governments, and with the key national economic agents on the side of labour and industry. It is crucial to increase investment incentives through structural policy measures such as deregulation and privatisation. Fiscal policy should continue along the path of diminishing adverse incentives provided by tax, benefit and pension systems, while reforms on the expenditure side of the budget are also needed for progress along the way towards the medium-term objective of attaining budgetary positions "close to balance or in surplus".

To sum up, although monetary policy cannot lift the euro area's growth potential, the benefits of price stability for growth are evident, as stable prices provide the proper environment for structural reforms to work. While the ECB will maintain its commitment to the maintenance of price stability, other policy-makers should assume responsibility for increasing the growth potential of the euro area. This, in turn, is the best allocation of responsibilities to contributing to sustainable non-inflationary growth in the euro area and, thereby, also at a global level.