Guy Quaden: The monetary policy of the European Central Bank and the economic outlook in the euro area

Speech by Mr Guy Quaden, Governor of the National Bank of Belgium and Member of the Governing Council of the European Central Bank, at a conference in Ottawa, 30 November 2001.

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For economists and financial markets, the euro has been reality since January 1st, 1999. The decisive steps were taken at that moment by irrevocably fixing parities between the different national currencies that continued to exist momentarily and the start of the single monetary policy conducted by the new European Central Bank.

For the general public, however, in Europe and elsewhere, the euro will only be real when it will at last be tangible in the form of notes and coins. In little over one month, on January 1st 2002, the euro banknotes and coins will become part of the every day life of more than 300 million European citizens in 12 countries. And, after an unprecedented logistical operation, at the end of February at the latest, 12 national currencies will have disappeared for good. At that moment, monetary union will have been achieved completely.

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To my mind, the implementation of monetary union in Europe can be explained by a series of long term structural factors.

First of all European integration is to a large extent a political process, having its roots in the two world wars that have devastated our continent in the first half of the 20th century. The Schuman Declaration of May 1950, which provided the basis for the European Coal and Steel Community, stated clearly that “solidarity in production will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible”.

Then came the deepening of economic and financial integration with the common market which has logically culminated into monetary union.

Finally, during the 1990s, a large consensus was reached regarding the objectives of a stability oriented macroeconomic policy which has contributed to a remarkable convergence towards low inflation and limited public deficits, without which monetary union would not have been possible.

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In the new monetary constitution of Europe, what we call the Eurosystem plays an essential role. It consists of the European Central Bank as such, that is situated in Frankfurt, and of the twelve national central banks of the countries that have introduced the euro. The Eurosystem is not to be confounded with the structure of any other central bank in the world, be they even of a federal nature. In the euro area, monetary policy decisions are centralised from now on, but their implementation remains to a large extent decentralised.

The Governing Council of the European Central Bank is the supreme decision-making body. It meets every fortnight and consists of the six permanent members of the Board of the ECB and of the governors of every national central bank. It is the Governing council which more in particular determines the level of official interest rates.

In practice, decisions are taken on a consensus basis, but according to the legal provisions they require a simple majority of votes. Each member has one vote: the vote of the governor of the National Bank of Belgium carries the same weight as the one of the president of the Bundesbank, the governor of the Central Bank of Luxembourg or the Governor of the National Bank of Belgium. The principle ‘one person, one vote’ thus reflects the fact that even though they are originally from different countries of the euro area, the members of the Governing Council act completely independently and not as representatives of their country. The Treaty specifically stipulates that they can neither ask for or receive instructions from their government or from anybody else and that they must take their decisions solely on the basis of the interests of the euro area as a whole.

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In granting the decision makers of the European Central Bank a high degree of independence, the Treaty of Maastricht- and I think these two things go together- has also assigned them a specific task: i.e. to guarantee price stability. Indeed, the Treaty clearly states that this is the primary objective of European monetary policy and that, without prejudice to this stability, monetary policy contributes to the other objectives of economic policy.

In every country in the world the population is, I think, of the opinion that the first duty of the central bank consists in maintaining the purchasing power of the currency it issues. But this mandate is particularly stringent for the euro area, as was the case previously for the Bundesbank in Germany. The people in Europe, and moreover not only in Germany, seem to be particularly attached to price stability.

Moreover, no central banker, and in any case not the members of the Governing Council of the ECB, is insensitive to growth and employment. But we think that growth should not be stimulated to the detriment of price stability, as such an action is short-lived and costly in the long term and monetary policy cannot resolve structural problems, in particular structural unemployment, which is important in Europe.

Furthermore, price stability contributes to economic growth by sustaining consumer confidence, an essential element of growth, and by favouring low long term interest rates, these rates being even more important for the financing of growth than short term rates in many European countries. (It must be observed that while for the moment short term rates are higher in the euro area than in the United States, long term rates are slightly lower).

The European Central Bank has given a precise definition of what she understands by price stability : price stability is defined as “an annual rise in the harmonised index of consumer prices for the euro area of less than 2 p.c. It must be maintained in the medium-term.”

Such a definition offers a stable anchoring point for the expectations of economic agents in an uncertain environment. It also offers the public a means to evaluate monetary policy, thus enhancing the transparency of the European Central Bank and enabling it to be called to account for its performance.

The expression “of less than 2 p.c.” specifies the maximum limit for the pace of inflation that is considered compatible with price stability. At the same time, the word “rise” clearly indicates that deflation must be avoided in the same way as inflation. By defining price stability at the level of the euro area, one clearly specifies that monetary policy is based on an assessment of developments at this level. Finally, when one speaks about maintaining price stability “in the medium term”, this means that one acknowledges the existence of short term price volatility, due to non-monetary influences and that monetary policy must be oriented towards the future (“forward looking”).

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To reach its target and to assess the risks weighing on price stability in a founded manner, the ECB carries out its analyses according to two separate, but complementary, analytical approaches. These are called the two pillars of the strategy.

In the first pillar, the emphasis is on the monetary origins of inflation, as inflation indeed remains ultimately a monetary phenomenon and the important role of money supply in the strategy also emphasises the responsibility of the Eurosystem for inflationary monetary pressures, which a central bank can more easily keep under control than inflation itself.

For the assessment within the framework of the second pillar, use is made of a wide range of other economic indicators, especially variables which have qualities as leading indicators of future price developments. These consist of, among other things, wages, exchange rates, bond prices, the term structure of interest rates, indicators for budgetary policy, various standards for measuring real economic activity, and the results of surveys among producers and consumers.

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If I make a short comparison between the monetary policy in the United States, Canada and the euro area, I observe a great similarity between the Bank of Canada and the ECB : price stability is clearly the primary objective of their policy, whereas the mandate of the Federal reserve is both wider and less specific. In your country quantifying the objective("inflation target") is subject to an agreement between the Minister of Finance and the central bank, whereas in the euro area, the central bank determines this autonomously. It is true that in the euro area we have twelve Finance Ministers! However the discretionary power of the Fed is greater still. But apart from these few differences, our three central banks share the characteristics of the major modern central banks : price stability is considered as a necessary condition for sustainable growth; they enjoy a high degree of independence in the conduct of monetary policy and simultaneously have a strong concern for transparency and accountability.

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During the first three years of the euro's existence, the European Central Bank has already been confronted with important and different challenges. At the start of the single monetary policy, in the beginning of 1999, its principal leading interest rate stood at a low level of 3 p.c. During the spring of that same year the ECB then has had to address a deflationary threat and lowered its rate to 2.5 p.c. Later on, primarily due to the steep rise in oil prices, but also of meat prices in Europe inflationary risks appeared which the ECB has sought to contain by gradually raising its interest rate from 2.5% to 4.75% between November 1999 and October 2000.

No central bank can avoid that a shock beyond its control, such as an oil shock, momentarily increases inflation. But the central bank has to prevent the increase of certain prices from transforming into an upward spiral of all prices and costs. The European Central Bank has succeeded in doing so. Euro area inflation reached a maximum of 3.4 p.c. at the beginning of the summer of this year; since then it has been declining and should according to all expectations drop below 2 p.c. in the coming months.

The reduction of inflationary pressures has allowed the European Central Bank to reduce its interest rates since the spring by 150 basis points in four moves (coming from 4.75 p.c., a level lower than in North America). These moves had moreover become desirable given the weakening economic activity in the euro area.

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The economy of the euro area has been affected, more than originally thought, by the slowdown in the United States, (which itself has been more important and long lasting than initially foreseen). Admittedly, since trade between European countries has become internal trade, from a monetary point of view, paid for in euro, our countries have become less dependent of their foreign trade as such. But other transmission channels have developed: European financial markets have grown, but Wall Street still sets the tone; as European companies have invested on a large scale in the United States during the last years, the height of their profits and investments is more influenced by their results on the other side of the Atlantic than was previously the case. Finally, different shocks, such as the increase in oil prices or the crisis of the new technologies have hit all industrialised countries and more recently the tragic events of September 11th have significantly increased uncertainty all over the world.

It is true that the economy of the euro area is running for the moment at a very slow pace. However economic activity should return to a much more satisfactory path in the course of next year. Normally the high level of uncertainty currently affecting the world economy should diminish. And, with the exception of the confidence of consumers and entrepreneurs, the conditions for a recovery are already present in Europe. I think of the gradual effects of the measures favourable to growth that have already been taken (interest rate cuts and in many countries also tax cuts); of the fact that inflation is low and is still declining and that financing conditions (both short term and long term interest rates) have become very favourable. Moreover consumers in the euro area are hardly indebted and there has been less excess in investments, which should make it easier for consumption and investment to take off again if non-economic uncertainty progressively recedes.

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Europe is not an island as we have seen in 2001. However, the full introduction of the euro should, without immunising us against external influences, allow the euro area in the coming years to register supplementary growth owing to supplementary stability, efficiency and visibility.

More stability: since the birth of the euro in 1999, much has already been achieved in this field. Within the euro area exchange rate fluctuations have disappeared. A framework has been set up for a macroeconomic policy aiming at stability, where monetary policy is oriented towards price stability and fiscal policy, within the framework of the so called Pact for Stability and Growth, towards sound public finances. These objectives are crucial for the confidence of economic agents and sustainable economic growth.

The single currency is also a major step forward in terms of more efficiency, by lowering transaction costs and increasing price transparency and competition, which will be even more evident once the notes and coins will have been introduced. Monetary union also intensifies the integration of European financial markets, which improves financing possibilities for companies. The single currency should also help speed up other necessary structural reforms in Europe.

Finally, the introduction of euro banknotes and coins will provide not only the new currency but Europe itself with more visibility all over the world. And within Europe, the use of the same notes and coins from Helsinki to Lisbon and Athens via Brussels will give the European citizens, much more than is now the case, the feeling of belonging to a community sharing the same destiny.