John Hurley: The monetary policy and operational framework of the Eurosystem

Address by Mr John Hurley, Governor of the Central Bank of Ireland, to ACI Ireland (Financial Market Association), Dublin, 12 February 2003.

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Introduction

I welcome the opportunity to address you here tonight. The ACI plays an important role in representing the interest of financial markets and in actively promoting the educational interests of its members. This raises the level of professionalism of the members and contributes to the smooth and orderly operation of financial markets.

I would like to concentrate this evening on the ECB dimension of the work of the Bank. I will begin by talking about the work of the Governing Council, and then go on to focus on monetary policy. Finally, I will talk about monetary policy implementation and the role that Ireland has played in the process.

Since I became a member of the Governing Council, I have been struck by two things in particular. The first is the breadth of its activities. Admittedly what are described as its basic tasks go well beyond the primary functions of the ECB. Still the range and depth of discussion in such areas as payment and settlement systems, foreign reserve management, production and issue of bank notes, statistics and so on was quite surprising; and this was following lengthy and detailed preparatory work by the Executive Board and by the twelve committees that work to the Governing Council.

Secondly, there is the democratic way in which the Governing Council goes about its business. In a sense one should not be surprised by this; the Statute of the ESCB provides for each member to have one vote and specifically restricts weighted voting to financial matters, and Treaty Article 107 is designed to ensure that Governors are not influenced by national considerations. But I am impressed by the manner in which these principles are observed in practice. Certainly there is no sense of Governors operating in a representative capacity when addressing Euro area policies. Equally, it is the force of an argument, rather than who makes it, that commands respect.

Currently we are preparing for the accession of ten countries to the EU, their participation in ERM II and their ultimate adoption of the euro. I should emphasise that this process will not fundamentally alter the procedure that I have just described. However, future expansions of the euro area require a change in voting modalities, with the introduction of the rotation of voting rights, in order to maintain efficiency in the decision-making process. The proposal is that Governors should be allocated eventually to three groups, with the voting frequencies in these groups determined in such a way as to ensure that, at any time, the euro area economy is adequately represented by those Governors having the right to vote. The first group will be composed of the five largest countries; Germany, France, Italy, Spain and, in time, if it joins the euro area, the UK, will all be members of this group. Ireland will be in the second group, along with countries such as the Netherlands, Belgium, Austria, Finland, Greece, Portugal and some of the larger accession countries. The remaining accession countries will all be in the third group. But all Governors, whatever their voting rights, will continue to attend meetings of the Governing Council and to participate fully in its discussions. What is more, should voting prove to be necessary – and it has not played a significant role in the Governing Council to date – each vote will carry exactly the same weight.

Prospects a year ago

Interest rates are, of course, the main focus of attention – and rightly so, given the ECB's primary objective of maintaining price stability. While a decision was taken in late 2001 to reserve the first meeting of the month for monetary policy discussions, such issues are never far from the thoughts of Governors. Indeed, we are currently engaged in a review of the monetary policy strategy, which has been in place since the start of EMU. As you are aware, the strategy is currently based on two pillars, namely money supply growth vis-à-vis a reference value and a broad range of non-monetary indicators geared to predict the medium-term outlook for inflation. After four years of operating the present strategy, it makes sense to take stock of our experience so far and to reflect on its various elements. But the fact that a review is being held does not in itself necessarily imply any significant change in the strategy.

A year ago, the background to monetary policy was – somewhat depressingly – not dissimilar to that obtaining at present. The general expectation was that there would be a gradual recovery of euro area economic activity over the course of 2002. Taking the year as a whole, while growth was projected to be modest – of the order of 1.2 per cent - the euro area economy was expected to attain its trend rate of growth by the end of the year. The view was that domestic demand should benefit from a number of influences; the absence of fundamental economic imbalances that would require a lengthy corrective process, the presence of favourable financing conditions, and a boost to real disposable incomes coming from declining consumer price inflation, which was expected to fall safely below 2 percent. On the external side, there were some early signs of stabilisation in the outlook for economic growth, but growth in the US was also forecast to be modest – around 1 percent.

In the light of the prospects for growth, the view in the markets was that short-term interest rates would rise somewhat during the course of the year.

Actual outcome

As we all know, things turned out rather differently. Euro area growth, at 0.8 per cent, was much less than projected, and most of it occurred in the early part of the year, with growth subsequently being disappointing. This outcome cannot be attributed directly to a shortfall in external demand. In fact, looking at the US first, economic growth for the year as a whole turned out to be considerably higher – at over two percent – than originally projected. But the patchy nature of that growth – with strong performances in the first and third quarters being succeeded by periods of economic weakness – contributed to a rise in uncertainty with regard to the international economic outlook; this undoubtedly had a dampening influence on the euro area. In some respects the fundamental factors retarding economic recovery were discernible at the time. The recession was clearly not long or deep enough to allow the economic and financial imbalances which had emerged during the preceding boom to be corrected. Here I'm talking about the low US savings ratio, excess production capacity and the current account deficit. Other factors, such as the scale of the decline in equity markets and geopolitical tensions, were less predictable. Equity market weakness was particularly important in driving the deterioration in business and consumer confidence in the second half of the year, and served to offset the impact of earlier US monetary policy easing. Its effect was felt through the resultant increase in the cost of investment and through its negative impact on household wealth. This reduction in household wealth, in addition to rising unemployment and uncertain growth prospects, exerted a negative influence on labour markets, offsetting the positive impact on consumer spending of the so called "equity extraction" that was facilitated by the strong housing market.

The euro area also had its own home-grown problems. While not on the same scale as in the US, excess production capacity has also had a dampening influence. The fall in equity markets in the euro area was in fact larger than in the US, and, while direct exposure to equity markets in the euro area is less than in the US, they have a major signalling effect. All of these factors contributed to a sharp fall in consumer and business confidence in most euro area countries. At the same time persistent inflation, partly associated with oil and food price increases, but also the result of structural rigidities, put a damper on consumer expenditure.

December interest rate reduction

Against the background of deteriorating economic circumstances and evidence that inflationary pressures, if not easing, were at any rate not worsening, it gradually became clear from around the middle of the year that the earlier expectation of a rise in official interest rates would not materialise. And by late Autumn, as the economic environment continued to worsen, it was increasingly evident that it was a question of when, rather than whether, the decision to reduce interest rates would be taken. And that decision, as you are aware, which was to reduce the key ECB interest rates by one-half of a percent, was taken at our meeting on 5 December.

A decision in relation to interest rates – to lower them, to increase them, or indeed to leave them unchanged – is rarely easily made. It is always a question of weighing up opposing factors and reaching a decision consistent with the medium-term goal of price stability. This decision was no exception; monetary growth was well in excess of the reference value, though this excess liquidity was largely the result of portfolio reallocation in an uncertain financial market environment and was unlikely to pose an inflationary threat. The annual rate of inflation in November was a little above 2 per cent, as it had been for most of the previous year, though this was partly as a result of transitory developments, such as the carry-over effects of earlier oil and food price increases and a limited impact from the changeover to the single currency. There was, however, strong evidence of a decline in inflationary pressures going forward, with economic growth remaining sluggish and increasing uncertainty exerting a predictable effect on confidence. The appreciation of the exchange rate was also expected to play its part in reducing inflation. Overall the assessment was that the prospect had strengthened for inflation to fall below 2 per cent in the course of 2003 and to remain in line with price stability thereafter.

Future prospects

The reduction in official interest rates came as the Eurosystem staff projections for 2003 pointed to a downward revision to both the growth and inflation forecasts. Notwithstanding these revisions, a gradual increase in growth over the course of this year was the central forecast, provided the current level of uncertainty gradually unwinds. Prospects have disimproved since then. In particular, the geopolitical and international economic uncertainties surrounding these projections have increased. While the last reduction in interest rates and the expected moderation in inflation provide some counterweight to the downside risks, it now seems certain that growth in 2003 will be lower than we thought, even as recently as the end of last year. To the extent that activity remains weak, inflation could fall by more than we projected. In such circumstances, there would be some room for manoeuvre on interest rates. The Governing Council is always ready to change rates whenever it deems such a move to be appropriate and it does not necessarily have to wait until the current uncertainties dissipate.

A significant development over the past year has been the sizeable appreciation of the euro from what was a clearly undervalued level. This should help to dampen inflation and ultimately improve purchasing power. However, the scale of the appreciation, if it were to continue, would undoubtedly slow activity somewhat. In the past, the relatively weak exchange rate of the euro has placed exporters to markets outside the euro area in a relatively favourable competitive position. This is no longer the case.

Because of Ireland’s stronger trading links with the US and the UK, the appreciation of the euro has a greater impact for us than it has for other euro area countries. In addition, our inflation rate – at over twice the euro area average – is becoming an ever increasing threat to our competitiveness and, hence, employment situation. I would reiterate, as we have stated for some time now, that this puts the onus back on prudent fiscal policy and appropriate wage and other cost developments to ensure stability.

The same is true for the euro area as a whole, with the added qualification of the importance of the need for structural reform to enhance the productivity of euro area economies. This brings us to the salient question of where growth is going to come from in the euro area. This is not an academic question: we in the euro area should be aiming to raise potential output above its current level of around 2¼ per cent; this is required if we are to reduce the euro area rate of unemployment significantly below its present unacceptably high level and to help prepare for the forthcoming ageing of European populations. And whatever about demand elsewhere in the world, we cannot expect the US to continue to be the engine of growth to the extent that it has been over the past decade; the likelihood is, rather, that its balance of payments deficit, which is currently around 5 per cent of GDP, will have to be corrected. Which means that Europe will have to generate its own growth to a much greater extent than in the past.

This should be possible with such a large, relatively closed, economy, but it will entail a significant degree of structural reform. I know that sounds like a rather jaded mantra coming form a central banker, but there is no getting away from it. Structural reforms inevitably involves short-term pain in pursuit of longer-term benefits. Such reforms are essential if the euro area is to raise its potential to generate non-inflationary growth and to reduce its high level of unemployment.

Monetary policy implementation

Turning my attention to the area of monetary policy implementation, I would like, first of all, to refer briefly to the TARGET system and the correspondent Central Banking Model – the so-called CCBM. TARGET has played a significant role both in monetary policy implementation and in the integration of the money markets in the euro area. The system has also helped to significantly reduce systemic risks associated with large value payments. Daily transactions are over €1½ trillion involving around 250,000 payments. The corresponding figures for Ireland are about €19 billion and 2,300. The Governing Council recently decided on the strategic direction of TARGET over the medium-term. This will involve the development of TARGET2, which will comprise a multiple platform system, including one shared platform to be used by central banks on a voluntary basis.

The CCBM is also an important component of the Eurosystem's operational framework. The CCBM is used for the transfer of cross border collateral in respect of borrowings by ESCB counterparties. At end-2002, just over €200 billion was held under the CCBM. At a level of about €15 billion, Ireland's share was disproportionately large, reflecting our importance as an international financial services centre.

In terms of how markets have functioned, I would like to start off by reminding you of just how much has been achieved. The market in Dublin was fully prepared for EMU in that the Bank had adapted its monetary policy instruments and procedures to the ECB model well in advance of EMU. We're four years into EMU now and we have seen many changes in the market. As you well know, the unsecured money market integrated very quickly, with the immediate introduction of the euro-area-wide standards: EONIA and EURIBOR. Other areas took longer, facing, for example, numerous institutional and legal hurdles. The introduction of Eurepo in March 2002 was a significant development in this regard. Integration of the short-term securities market is the next target. In this regard, the ECB was pleased to act as host for the recent consultation of the market on behalf of the ACI on the issue of how the European short-term securities markets could be further integrated.

I think that it is true to say that the Central Bank has played and continues to play a full part in the whole monetary policy implementation process. At the operational level, Central Bank staff carry out the Eurosystem's money market management operations with Dublin based banks. The banking system in Ireland actually takes a disproportionately high share of funding in ECB operations. This reflects the importance of Dublin as a financial centre, as testified by the still growing number of financial institutions choosing Ireland as a location for their operations. We have also participated in the very limited number of Eurosystem foreign exchange market interventions. Perhaps surprisingly, as part of the Eurosystem we carry out regular market transactions with a greater number of domestic institutions, and for much larger amounts, than was the case before joining the system.

At a strategic level, the Bank had a full input into the evolution of the monetary policy framework. This applied both when the Eurosystem operational framework was being designed and in its subsequent adjustment to changing market circumstances. In fact, our pre EMU experience in the active management of the local markets has proven to be very beneficial in this regard.

The Eurosystem institutional set-up, involving centralised decision-making on monetary policy issues and decentralised implementation of policy presents special challenges in the area of communication. There are a number of ways by which the Eurosystem keeps in touch with market developments and opinion and I would like to outline a few examples for you here tonight. Local market views are collected by the Bank and provided to the ECB daily – many of you will recall being contacted as part of this process. Together with the views of the rest of the euro-area market, these play a part in the ECB's management of the euro money market. We also conduct annual money market surveys and periodic FX market studies, which feed into wider euro area market studies, and these in turn are published by the ECB. Another communication forum is the Dublin Markets Contact Group. This is a group of banks representative of the local market, which meets under the auspices of the Bank's Financial Markets Department. The Bank uses this forum to provide feedback from similar groups established at Eurosystem level while local issues that arise at the Dublin Contact Group are fed back to the ECB as appropriate.

The ECB itself is also fully committed to public consultation in advance of making decisions and such an exercise was undertaken recently on the operational framework for monetary policy. Market participants' views were requested regarding three separate issues: a change in the timing of the reserve maintenance period; a shortening of the maturity of the Main Refinancing Operations from the current two weeks to one week; and a possible suspension of the Longer-Term Refinancing

Operations. The Eurosystem received a strong response to this public consultation. Irish institutions were among the most prominent in the number and comprehensiveness of their responses.

The public consultation was well received by market participants, and from the ECB's point of view it was felt that the consultation process produced valuable additional input with regard to the planned changes. It is no secret that there was a lot of opinion in the market against abolishing the Longer-Term Refinancing Operations, with many counterparties arguing that these operations continue to play a meaningful part in managing their liquidity needs. The Governing Council took these concerns into account in their deliberations and in the event announced on January 23rd that it would not suspend the Longer-Term Refinancing Operations but that it would implement the other two suggestions. Given the preparatory work required, these measures are scheduled to come into effect during the first quarter of 2004.

I would also like to take this opportunity to remind you that monetary policy formulation at the supra-national level does not mean that this is at the expense of recognising the differences in local market conditions. In fact, the decentralised arrangement has distinct advantages in terms of using NCB's in-depth knowledge of their local markets and liquidity conditions. Nor does the current set-up preclude flexible and timely responses to market developments. For example, the Eurosystem was also able to respond in a cohesive manner to the conditions that prevailed in the aftermath of tragic events of September 11th. The ECB rapidly announced its willingness to support the normal functioning of markets and provide additional liquidity if needed. We at the Central Bank played our role alongside the rest of the Eurosystem in responding to the situation. Local market participants took part in both the fine tuning operations of September 12th and 13th and in the liquidity providing dollar foreign exchange swaps.

The past four years have not been without difficulties however. One such difficulty was the overbidding problem that arose under the fixed tender MRO system. As you know, this was particularly disadvantageous to institutions like those in Ireland without recourse to large amounts of collateral. The move to the variable rate system in mid-2000 virtually eliminated the problem of severe overbidding which in turn provided Irish counterparties with the scope to increase their share of funds considerably – which, in fact, they did. Subsequently the phenomenon of underbidding emerged as the market anticipated reductions in official interest rates. The measures contained in the current public consultation and which have just been approved by the Governing Council are designed to eliminate this problem.

Concluding remarks

I would like to conclude by saying that the Eurosystem has now become such an established component of the international financial system that one is inclined to forget that it is only four years in existence. The considerable technical and operational challenges to implementing a single monetary policy across twelve countries have been successfully met. This is due in no small part to the highly efficient manner in which financial markets across the euro area have functioned. Monetary policy implementation and the collateral framework are, of course, subject to ongoing review and there will, no doubt, be issues to occupy you well into the future.

As regards the conduct of monetary policy, the Governing Council has a good record in maintaining price stability over the last four years. We are currently living in uncertain times. To the extent that activity remains weak, inflation could fall by more than we projected last December. If this looks like happening, we will have to reflect further on the monetary policy stance. I thank you for your attention.