

Vítor Constâncio: The performance of monetary policy during the past five years

Speech by Mr Vítor Constâncio, Governor of the Bank of Portugal, at the dinner in honour of the Governing Council of the European Central Bank, Queluz, 2 October 2003.

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Prime Minister,
Minister of State and Finance,
President of the European Central Bank,
Colleagues,
Ladies and Gentlemen,

It gives me great pleasure to welcome you all in this place full of history on the occasion of a meeting of the Governing Council of the European Central Bank. We meet twice a year outside Frankfurt and this constitutes an important expression of the decentralized nature of the Eurosystem. It also underlines the accountability of the ECB to all national constituencies and the importance we attach to the need that our activity should be understood and supported by public opinion in all member states. The decentralized system that we operate has worked well and it is therefore fortunate that the draft Constitutional Treaty about to be discussed in the coming Inter-Governmental Conference, has left untouched the basic principles and organization of the Eurosystem. I think this is wise in view of the delicate balance that a major sharing of sovereignty among nations always requires and the need for stability that monetary institutions always deserve.

European Monetary Union has been a great historical achievement and the past five years were marked by several accomplishments: the smooth efficiency of its beginning, the building-up of a new international institution, the successful introduction of euro notes and coins and, in particular, the delivery of sound monetary policy. Many have contributed to make this possible but it is justifiable to stress the importance of good leadership for the whole endeavour. So, I think it is appropriate to take this opportunity to pay tribute and express our gratitude to Wim Duisenberg for his role as the first President of the ECB. I am sure that time can only enhance the assessment of his contributions to European monetary history. We were fortunate to have him as our leader but, at the same time, we feel secure regarding the future as the Presidency passes into the experienced and competent hands of Jean-Claude Trichet.

This is then a good moment to briefly take stock of the performance of monetary policy during the past five years, both from a general perspective and from the point of view of a country such as Portugal. With time and after the correction of an early depreciation of the euro with no basis in the fundamentals, the public assessment of our monetary policy has become positive, both in the markets and by academics. In fact, it has been impossible to ignore the good performance indicators. In the first place, the overriding objective of price stability has been ensured with an average inflation for the whole period of two per cent. This was accomplished in spite of supply shocks that negatively affected the inflation rate, such as the sudden increase of oil prices from 1999 to 2001.

As important as the actual inflation rate achieved, stands the fact that we have managed to stabilize the medium term expectations of markets regarding future inflation, at a value slightly below 2%. This is a very important result as it means that the Eurosystem is seen as credible enough to deliver long term price stability. This increases our margin of manoeuvre to reduce economic volatility and to better ensure the overall objective of non inflationary growth. The Eurosystem, as the central bank of the euro area, is now recognised as a credible institution and the euro as a robust and reliable currency.

Markets and economic agents in general have learned to understand the underlying framework of our monetary policy with the important result that we have become a more predictable institution. This implies that we can better manage expectations and implement monetary policy while maintaining smooth functioning of money markets. At the same time, throughout this period, monetary policy has been supportive of economic activity. Liquidity has been appropriate, as money supply and credit growth were clearly favourable to economic expansion. Monetary policy cannot be made responsible for the present weak economic conditions when the level of interest rates has been the lowest for decades. In our case, we have to go back 45 years to find interbank market rates similar to the ones now prevailing.

I stress this point not to contradict the idea that the best way for monetary policy to contribute to long-term growth is by ensuring an economic climate of price stability. It is well known that monetary policy is not able to directly affect the level or growth of potential output. The clear hierarchical mandate we have to give priority to price stability, does not exclude the flexibility and pragmatism essential in the implementation of policy in order to reduce short term volatility in an uncertain environment. Let me recall just two examples. In April of 1999 our main refinancing rate was lowered to the then unprecedented level of 2.5 per cent, when inflation was around 1 per cent and the economy was showing signs of weakness. Focussed on avoiding possible deflationary risks, that decision meant that the Governing Council was taking insurance against more negative developments which, although not the most likely to occur, were nevertheless possible. The other example refers to the cut in rates decided in May 2001 when headline inflation was above 3 per cent but the world economy seemed to be on the brink of recession and there were no risks for medium term inflation.

This flexible approach was appropriate in both cases and was validated by subsequent events. Monetary policy cannot be transformed into a dogmatic and mechanical science and it will always be necessary to use good judgement to properly assess the balance of the risks regarding inflation prospects. The same assessment of risks that is also essential to good communication with markets which has become such a crucial part of the activity of central banks. The recent clarification of our monetary strategy, in particular concerning the goal of price stability now defined as implying an inflation rate «below but close to two per cent», was thus important to improve communication and to ensure the continuation of good monetary policy for the euro area.

Turning now to our own national perspective, it is clear that Portugal has been a net beneficiary as a participant in the European economic and monetary union. Among other things, we have taken advantage of our trade interdependence with Europe through currency stability; we imported a low inflation regime that is good for long-term growth and we have benefited from financial integration that granted us lower bond rates and a lower cost of capital. There are obviously risks involved and the need to adopt new and rigorous discipline concerning public finance and flexibility of markets in order to achieve timely adjustment of wages and prices. In view of a past history of high inflation, Portugal could be considered a good candidate to illustrate what some critics underline as the great difficulty of a single monetary policy in dealing with a group of heterogeneous economies. In our case, however, the performance of the economy throughout this period does not confirm these possible causes of concern. Since 1999 Portugal has had an average positive inflation differential with the euro area of only 1.2 per cent and an average annual output growth of 0.5 per cent higher than the one of our partners. Considering the overall picture, the dispersion of inflation in the euro area, after only four years, is remarkably similar to the one verified in much older monetary unions like the USA or Canada. What some critics seem to forget is that monetary union itself contributes to the deepening of economic and financial integration, by promoting the medium term convergence of inflation and the synchronization of the business cycle. These developments contribute to dispel the risks of asymmetric shocks in the future. What does not disappear is the risk of an initial period of excessive expansion of expenditure and debt after joining a monetary union that guarantees a regime of low inflation and low interest rates. We have felt the consequences of this hazardous development. The economy, however, has automatic correcting mechanisms as economic agents soon have to begin restraining their indebtedness and adjusting their spending. In spite of the restrictive nature of this mechanism we could have achieved a gradual soft landing of the economy if two new factors had not made their appearance: the strong deceleration of the world economy and the budget crisis that emerged in 2001. The Government had to adopt difficult measures of budget consolidation to reduce the structural deficit from -4.6 per cent of GDP to -2.5 per cent last year. The recession we are now going through, with annual growth this year around -1 per cent, is making things more difficult for fiscal policy. More than others, we would have justification not to comply exactly with the present fiscal rules. However, as small nations always have to try harder, we still hope to be able to cope with the situation, in spite of being very much dependent on developments of the world economy.

An economic recovery is definitely coming, even if some doubts remain about its intensity or duration. In fact, uncertainties remain in connection to the large unbalances existing in some economies. It is deceptive to think that everything can be solved by exchange rate adjustments. The problem is one of saving rate insufficiency and will require internal financial adjustments.

In the process of global economic adjustment Europe should not bear the main burden of exchange rate corrections. The responsibility of Europe is to implement the necessary reforms in order to increase its rate of potential growth. We need to deal with the very serious consequences of negative demographic developments, of technological shortfalls and the requirements to flexibly adjust markets

to the demands of the new international environment. We need good structural policies to restore confidence in the future. These reforms are a condition to preserve the basic features of the European model, that particular combination of stability, growth and social cohesion that has made Europe a beacon of civilization. It is indeed in Europe that one can find the most humane and progressive societies compatible with the human condition. But, in the present world environment, like in the hegelian "aufhebung", we have to transform in order to maintain. What we have to preserve comes from our common cultural heritage. If by society we mean a community of men living under a system of «opinions, norms, desires and beliefs», then Ortega y Gasset was right to say that «the European society has historically preceded all European nations». The reality of nations cannot, of course, be ignored as they are our main form of socialization and the place where predominantly we exercise our rights. But they are now part of a wider community. The euro is the more important manifestation of our common bond and a great rampart that defends our economic and social autonomy. But more is needed. A recent large inquiry organized by the German Marshall Fund showed that 71 per cent of Europeans want the European Union to become an international power. The new Constitution, now in preparation, is an opportunity to give form to what the present european consciousness expects of our Union. Let us hope that, as a result of our endeavours, we will be able to say about the near future of Europe what Ortega said about the role of culture: «a moment of clarity in the confusion of the world».