John Hurley: Euro area monetary policy and EU enlargement

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to ACI Ireland, Dublin, 22 March 2004.

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First, let me say how pleased I am to have the opportunity to share some thoughts with you this evening. I would like to begin by saying a little about the euro area monetary policy framework, which was reviewed and clarified last year, before going to outline how monetary policy in the euro area has been conducted in the first five years of EMU. I will then turn my attention to the current monetary policy environment and recent exchange rate developments, before looking at some broader structural and fiscal policy issues and, finally, speaking briefly about the imminent enlargement of the EU.

The euro area monetary policy framework

Turning on to euro area monetary policy, for just over five years now the euro area has had a single currency and a single monetary policy conducted by the Governing Council of the ECB. The introduction of the single currency has been an historical landmark. In twelve countries, the euro has replaced the national currency and rapidly become part of everyday life. For the business community, intra-euro area exchange rate volatility and the uncertainty it caused for trade and investment have been eliminated. In the financial area, the role of the euro in global markets and the growth in the use of the new currency outside the euro area over the past five years have also been impressive. The euro has very quickly become an important part of the global financial system and the evidence of the past five years is that its role will continue to grow for some time yet.

Within the euro area, the key challenge has been to formulate and implement the single monetary policy. Since it is a "one size fits all" policy, many doubts were initially expressed about whether it was possible or not to formulate a common monetary policy for such a diverse area. I think our experience to date is that the policy is successful. In practice, the Governing Council formulates policy in much the same way as many other central banks, that is, it focuses on controlling inflation. There are significant benefits to be derived from keeping inflation low: it supports consumers purchasing power; it avoids the misallocation of resources associated with inflation or deflation; it serves to reduce uncertainty and risk premia in financial markets, ultimately facilitating lower medium and long-term interest rates, and it is an important anchor for wage developments and for the enhancement of competitiveness in the economy. In short, maintaining price stability is the key contribution that monetary policy can make to achieving sustainable growth and job creation.

Being clear about its mandate, and how it fulfils it, helps a central bank to foster credibility. To ensure that monetary policy firmly anchors inflation expectations from the very start the Governing Council adopted a monetary policy strategy which is forward-looking, focussed on the medium-term and broadly based. To be successful in maintaining price stability it is also important that the rationale for decision-making is clearly understood. As I am sure you are aware, this is an area which had been the subject of some criticism in the past. Reflecting this, after four years of experience, the monetary policy strategy was reviewed and clarified in 2003.

Two important points of clarification emerged from this exercise, which address misunderstandings which had emerged. First, as regards the definition of price stability, it has been clarified that the objective is to maintain inflation, for the euro area as a whole, at a rate below but close to 2 per cent over the medium-term. Second, as regards the assessment of the risks to price stability, the review clarified the way in which the Governing Council integrates the signals coming from the economic analysis, on the one hand, and the monetary analysis, on the other. In particular, it is made clear that the monetary analysis mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications for inflation coming from the economic analysis.

The conduct of monetary policy since 1999

Having outlined how the Governing Council formulates and implements euro area monetary policy, I would now like to make a short assessment of the conduct of that policy over the past five years. In its early years, the single monetary policy has been conducted in a very testing environment, characterised by a series of shocks. At various times in the past five years there have been periods of exceptional economic, financial and geopolitical uncertainty. The first 18 months witnessed a tripling of oil prices, the peak of the dotcom boom and a significant fall in the value of the euro. The subsequent correction of the sizeable imbalances generated by the late 1990s boom, allied to heightened geopolitical tensions, then triggered the most critical and sustained period of economic and financial uncertainty witnessed in decades. This uncertainty persisted until last Spring, and while it has unwound considerably since then, some of its effects still linger. On top of all this, we have also seen a sharp appreciation of the euro, particularly against the dollar, which has taken it to a level that is higher than at its initial launch. From that short outline, it is clear that the economic and financial environment of the past five years has provided a stiff test of the single monetary policy.

Given this background, what has been the outcome? Over the past five years, the evidence indicates that both inflation and inflation expectations, which signal the rate of price increase anticipated in the future, have remained firmly under control. Since the beginning of 1999, indicators of long-term inflation expectations in the euro area have remained below but close to 2 per cent. This suggests that the new single monetary policy has been successful in anchoring long-term inflation expectations and that the public and the markets are convinced about the determination to maintain price stability over the medium-term. This has been a very significant achievement in a relatively short period of time and has been an important factor in permitting euro area interest rates to fall to their lowest levels in decades.

It should also be recalled that, before the establishment of the euro and the single monetary policy, there were significant differences in long-term interest rate levels across countries. A key achievement, and also an indication of the credibility of European Monetary Union, has been the convergence of long-term interest rates to the lowest level prevailing in the area and not just to the average level. This has helped to improve financing conditions in many parts of the euro area. Allied to the fact that intra-euro area exchange rate volatility is also now a thing of the past, this has created a much more favourable environment for consumers, the business community and investors.

Recent developments and background

In recent years, the main influence on monetary policy, both in the euro area and globally, has been the heightened economic and financial uncertainty which persisted until mid-2003, and the after-effects of which have still not fully dissipated. Against this background, already exceptionally low global interest rates were reduced further. In the euro area, with inflation and inflation expectations under control, the Governing Council lowered interest rates on two occasions, March and June 2003, effectively bringing rates to levels equivalent to post-World War II lows.

For the euro area, 2003 was the third successive year in which economic growth decelerated. For the year as a whole, the euro area economy grew by only 0.4 per cent, a most disappointing performance, considering that the economy had already registered below potential growth in both 2001 and 2002.

However, these average figures mask the fact that, after several years of below par growth, a gradual recovery in activity has been underway since around the middle of last year. The main impetus to the euro area recovery has come from the improvement in the global economic performance, which, in turn, reflects a number of factors. Initially, there was the unwinding of geopolitical uncertainties, which facilitated a rebound in confidence, especially business confidence, over the second-half of last year. More fundamentally, however, the recovery, particularly in the US, has acquired considerable momentum from the sizeable policy stimulus put in place in recent years; indeed the scale of this stimulus itself poses some medium-term risk to the continuation of the recovery there. Further contributory factors were the performance of equity markets, which rallied considerably over the course of last year, and also the unwinding of the investment overhang created during the late 1990s boom, which removed an important headwind to growth. The improvement in the global economic environment, however, does not simply reflect developments in the US. Growth has also resumed in Japan, and accelerated in both the UK and East Asia, where, in both instances, the slowdown had been less pronounced.

The current euro area monetary policy environment

In the case of the euro area, the recovery clearly has lagged that of most of the other major economies. As was the case elsewhere, the strong gains in euro area business confidence, from last summer onwards, suggested that growth was going to gather momentum. While third quarter data seemed to confirm that recovery was taking hold, activity was being driven by a solid pick-up in exports, with domestic demand remaining weak. Notwithstanding the rise in the value of the euro, the stimulus from a more strongly growing global economy was driving euro area growth.

The scenario which appeared to be unfolding at that stage was one where stronger export growth would generate a recovery in production. This would stimulate investment and would be followed, in turn, by a pick-up in consumer spending.

Although this recovery scenario remains broadly in place, progress has been slow. While we have seen an externally-led rebound which has boosted industrial production and helped generate some rebound in investment, the recovery has not yet become broadly based. In particular, domestic demand remains subdued. To a large extent, this reflects the weakness of consumer spending, which has yet to show much sign of improvement. There has been only a modest recovery in consumer confidence since the middle of last year. Continuing uncertainty about labour market prospects and job security have not helped and may be leading households to maintain savings at somewhat higher levels for precautionary motives. Moreover, more recently, the signals with regard to the nature of the recovery have become somewhat mixed. They continue to point to expansion, but at a gradual pace. For example, neither the level nor composition of recent fourth quarter GDP growth, where sluggish consumption and net trade were offset by a strong inventory build-up, suggest that the momentum of recovery is likely to accelerate in the near term.

Notwithstanding this, many of the conditions needed for a recovery in private demand are in place. Most of the headwinds that have held back economic activity in the past couple of years have dissipated. Real short-term and long-term interest rates are very low, making financing conditions very favourable. In addition, the strong global recovery should help offset some of the drag resulting from the strengthening of the euro.

However, while this should help ensure that the recovery continues, the pace of improvement seems set to be slow. Against this background, there is likely to be little upward pressure on inflation and the outlook for price stability in the medium-term is favourable.

That the recovery is taking so long to gain traction reflects the fact that there are still uncertainties and risks to the outlook. In the near term, as I have mentioned already, these relate to the prospects for euro area consumer spending. Until there is some improvement on this front, the euro area recovery will continue to be unconvincing. The longer-term risks relate to concerns about the sustainability of economic growth at the global level given the persistence of, both internal and external, imbalances in some parts of the world. Both sets of risks suggest that a sustainable recovery cannot yet fully be taken for granted, though it still remains the most likely prospect. While our view is that the current stance of monetary policy remains appropriate, I can assure you that the Governing Council remains vigilant and will closely watch developments in coming months.

Exchange rate developments

I would now like to say a few words about exchange rate developments, which, of course, the Governing Council takes into account as part of the overall economic analysis. In the early years of EMU, the relatively weak exchange rate of the euro placed exporters to markets outside the euro area in a relatively favourable position. This is no longer the case. While exchange rate appreciation helps to dampen inflation and ultimately improve purchasing power, it also obviously impacts on the net trade position. So far, the positive effect of stronger global growth has outweighed the negative impact of exchange rate appreciation on euro area exports. More recently, however, there has been some evidence from sentiment indicators of a moderation in export orders, and industrial production fell in January.

The euro has been trending upwards, both against the dollar and in overall terms, for just over two years now, and there have been sizeable movements in exchange rates over the past six months. In particular the appreciation of the euro accelerated considerably against the dollar and also Asian currencies in late 2003 and the first half of January 2004. These movements were linked with imbalances at the level of the global economy, such as the US current account deficit. They also reflected the fixity of some Asian currencies vis-à-vis the US dollar, which led them to depreciate in line with the US currency. The speed and strength of the appreciation of the euro over this period raised concerns and, while the gradual and smooth correction of global imbalances is an important medium-term issue for the global economy, it must be achieved in an appropriate manner. Viewed in this way, excess volatility and disorderly movements in exchange rates are undesirable. The G-7 statement issued in Florida on 7 February recognised this risk. The statement emphasised that greater flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustment in the international financial system, based on market mechanisms. While I recognise that there have also been other factors at work, I am encouraged by the fact that since the recent G-7 meeting, we have seen greater stability in foreign exchange markets.

The importance of an appropriate policy mix

I will now briefly touch on the issue of the euro area policy mix. There is sometimes a misconception that the single monetary policy is in some way anti-growth. I can assure you that the single monetary policy is not anti-growth. Not only has it had the positive effects I have described earlier - anchoring long-term inflation expectations, thus, facilitating low short and long-term interest rates - the ethos of the policy is not in any way opposed to growth. In fact the opposite is true. The aim is to support growth. The Maastricht Treaty makes it clear that, while the primary objective of monetary policy is price stability, the Eurosystem should, without prejudice to this objective, also take into account the broader economic goals of the European Community. Sometimes it is overlooked that monetary policy operates in tandem with other policies and there are strong complementarities between them. Monetary policy has been successful in ensuring price stability and delivering low short and long-term interest rates. However, other elements such as a sound fiscal policy, a stable macroeconomic framework and sufficiently flexible labour and product markets are also necessary to achieve strong and sustainable growth.

Structural Reform

Reflecting this, an important commitment of the Irish Presidency of the EU is to progress the structural reform agenda. As a member of the Governing Council, I welcome this initiative. Why is structural reform an issue for a central bank? There are a number of reasons. Increasing the efficiency with which markets operate raises potential growth. Importantly, also, a more efficiently functioning economy will utilise the resources available to a greater extent and, in doing so, will be less prone to inflation. This extends the boundaries within which all economic policies, including monetary policy, can operate without generating inflation. In effect, the economy will have a higher growth “speed limit” i.e. it will be able to grow faster before inflation is likely to become a problem.

The structural reform agenda, set out in the Lisbon Strategy of 2000, aims to improve the functioning and flexibility of euro area product and labour markets. This is to be achieved through raising employment rates, education and skills levels and promoting technological innovation. While, in terms of time, we are nearly halfway through the Lisbon process, progress in meeting targets has been slow. While most EU countries have undertaken initiatives for labour market reforms in recent years, achieving the target employment rate of 70 per cent of the working age population is still far off. Moreover, further reforms are needed to allow wages to reflect more strongly regional and sectoral productivity differences and also to improve education and training systems. The emphasis placed on these issues is to be welcomed and their achievement has the potential to contribute materially to boosting the long run sustainable growth rate of the euro area.

Stability and Growth Pact

The link between monetary and fiscal policy is, I think, readily appreciated. The Stability and Growth Pact, together with the Maastricht deficit and debt objectives, constitutes the euro area’s fiscal framework. There are two main reasons why we need such a framework. First, given the divergent structure between centralised monetary and exchange rate policy, on the one hand, and decentralised fiscal policies (i.e. at the national level), on the other, a rule-based fiscal framework is necessary to avoid conflicts between monetary and fiscal policy. By adhering to fiscal rules, within a broad framework, divergent fiscal behaviour of individual Member States can be contained. This fiscal discipline, in turn, supports low interest rates, which is essential for good long-term economic performance. Secondly, and this will become increasingly important in the years ahead, low public debt will help Member States to prepare for the budgetary impact of ageing populations.

As you are aware, however, there have been difficulties in the application of these rules. The recent budgetary experiences of some large Eurozone countries demonstrate clearly the problems that can arise in relation to the 3% deficit limit, especially when insufficient provision is made during economic upturns. The decision by ECOFIN on November 25th to “hold in abeyance for the time being” the excessive deficit procedure against these countries has given rise to much talk about the status of the Pact. Clearly the Governing Council is concerned about this situation, because of the impact such an action can have on the ECB’s core mandate to attain and maintain price stability, and it respects the Commission’s decision to seek legal clarity in this regard. But, it is important to emphasise that, while the Governing Council does not see a need for change in either the Treaty or the Pact, it does, however, agree that it is possible to improve its implemention in certain respects. For instance, the analysis of structural balances and the incentives to pursue sound fiscal policies in good times could be strengthened and improved. And there si also scope to enhance the clarity and enforcability of the framework overall. These are undoubtedely issues that will be considered in the future.

Enlargement

On 1 May, we look forward to having ten new members of the European Union. While the immediate contribution (5 pre cent) to the level of output may be relatively modest, at a stroke the area of the EU will expand by 25 per cent and its total population by 20 per cent.

In due course, also, enlargement could have major implications for the governance of the ECB. Several acceding countries have signalled their intention to adopt the euro within the next few years, and, most, if not all, may well be part of the euro area by the end of this decade. In the meantime, there is much ground to be covered. The starting point for the acceding countries is that, once a country joins the EU, it is obliged to treat its exchange rate policy as a matter of common interest and it is in that context that the question of participation in the exchange rate mechanism arises. An acceding country is not obliged to participate in ERM II, but is expected to do so and it can join the mechanism at any point, subject to agreement on the central rate and fluctuation margins. Economic conditions among the acceding countries differ greatly, as far as nominal and real convergence are concerned: to give just one example, GDP per capita, as a percentage of the euro area average, ranges from 37% in Latvia to 80% in Cyprus; but there are also significant differences in unemployment, inflation rates, and fiscal positions. It, therefore, makes sense that, throughout the process leading to the adoption of the euro, assessment be carried out on a case-by-case basis.

Participation in ERM II is something to which we in the Governing Council attach considerable importance, as a preparation for the rigorous regime that lies ahead. For the acceding countries, however, the focus is on the adoption of the euro, which will bring considerable benefits in terms of greater policy credibility and the absence of exchange risk for much of their external trade. But, ultimately, in the interests of the acceding countries themselves and in the interests of a successful euro, the bottom line is that all those adopting the euro must be able to live with its constraints. Hence the need for adequate preparation before adopting the euro and, indeed, joining the exchange rate mechanism.

We in Ireland may have something to offer from our experience. Some of you will recall in the early 1980s, we had 20% inflation and twin deficits well into double figures. We resolved these difficulties by the late 1980s, but still experienced pressure on exchange rate and monetary policy through most of the wide band period as we tried to achieve nominal convergence, while containing some of the pressures generated by real convergence. Some acceding countries are facing similar issues. Our experience underscores the need for policy makers to be aware of the changes needed to help them prepare for EMU. But, having said that, these are essentially short-term matters. Over the longer term, the positive impact of accession on the EU economy could be immense. In particular, I would expect the energy and dynamism released by the catching-up process to percolate through to the rest of the EU, not least as a catalyst in creating a more competitive environment and in hastening structural reform. Enlargement on this scale is unique, and we in Ireland, who currently occupy the presidency of the EU, are privileged to have enlargement on our agenda.

Conclusion

The first five years of EMU can be considered a success. More than three hundred million consumers and investors in the euro area have enjoyed the benefits of price stability, low nominal interest rates in a single money market and the convenience of dealing in a single currency over a wide geographic area. By maintaining price stability, monetary policy provides the basis for sustainable growth in output and employment. But, for growth to materialise, the active support of fiscal policy and structural reform is also required. I believe that there is a growing awareness across the euro area of the need for both to play their part in addressing current problems and to prepare for the coming challenge, especially that of ageing populations. I expect these issues to be centre stage over the next five years.