Jean-Claude Trichet: Current issues on the European Central Bank and the euro

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Club International La Redoute, Bonn, 27 September 2004.

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Ladies and gentlemen,

It is a great honour and pleasure to speak to the Club International La Redoute here in Bonn. Tonight, I plan to share with you some reflections about the ECB and the euro which has now been with us for quite a while. Contrary to what some critics had predicted before its launch almost six years ago, the euro has been a success from its very start. From day one of its existence, we have managed to deliver what we promised to deliver - that is a new single currency that would be at least as good and confidence-inspiring as the best performers among the previous national currencies were prior to the introduction of the euro.

That is why I would like to share with you some thoughts on the main factors, principles and mechanisms which helped the ECB to make the euro a success. I would also like to elaborate on the implications of the historic enlargement of Europe for the future integration of new Member States in the field of monetary policy.

My first remark relates to the successful transition to the euro

With the introduction of the euro almost six years ago we engaged in a grand enterprise that irreversibly tied together the economic and monetary destiny of eleven, then twelve, sovereign nation states. We were asked to deliver a new single currency that would be at least as good and as credible as the most credible ones among the previous national currencies - and we promised to deliver. It was a solemn promise made to the more than 300 million people in Europe. It was crucial for a smooth transition to the euro. Had we failed in meeting this promise, a number of people in Europe would have seen their medium and long term market interest rates rise at the moment of transition, reflecting the deterioration of the quality of the new currency.

At the same time, to meet this promise was extraordinarily demanding because the success of the transition to the euro was very much depending on the immediate achievement of a high level of credibility. And this credibility in the delivery of price stability had to be intact not only in a two-year or five-year perspective, but also on a ten-year and even thirty-year basis.

I well remember that, before we started our work, success was not taken for granted. Sceptics doubted that it was possible to establish the euro as a stable currency and to successfully formulate a monetary policy for a currency area, so diverse in many respects. In particular, the coexistence of sovereign national fiscal policies and a supranational monetary policy was considered as a dangerous mixture. The single approach implied by the single monetary policy was criticised as a serious hindrance to further economic convergence. Some sceptics even took the view that a stability-oriented monetary policy was bound to fail in such a situation.

Where do we stand today? The experiences over the past five and a half years make it clear that the euro has been firmly established as a stable and credible currency. The introduction of the euro both in book-entry form and in the form of banknotes and coins went extremely smoothly and was virtually free of technical problems. In January 1999 we established almost over night a unified money market which worked well from the very start. New payment systems for large-value transactions were implemented successfully. Three years later the introduction of the euro notes and coins, which was a unique logistical undertaking, took place smoothly, without any major hitches.

Equally important, the ECB’s monetary policy has been successful in keeping inflation and inflation expectations under control, even in the face of exceptional uncertainty and a number of substantial, mainly upward, price shocks hitting the euro area economy. To a large extent, the ECB’s monetary policy has been operating in a context of exceptional economic, financial and geopolitical uncertainty, as was for instance the period following the traumatic terrorist attacks of 9/11 three years ago. It is my strong belief that the euro and our single monetary policy have considerably contributed to protecting our economies which otherwise could have been much more adversely affected.

With a view to anchoring long term inflation expectations we kept a steady hand and never overreacted, which bears testimony to our capacity to weather difficulties. We succeeded in delivering the best yield curve available in the economies that were to form the euro area. This was in sharp contrast to the view of some observers who argued that the quality of the euro as a new currency would converge only towards a sort of arithmetic average of the legacy currencies, rather than to the benchmark set by the most credible national currencies that were merged into the euro. In fact, what happened is that the very low market interest rates that existed only in a small number of economies were immediately extended to the full body of the euro area. Long-term inflation expectations aligned with the low levels of the best performing economies that were merged into the euro. As a consequence, with nominal and real interest rates at historically low levels, Europe now enjoys much more favourable financial conditions than in the 1990s.

This success is all the more remarkable given that the ECB started without a track record of its own. In this respect, we can say today that the ECB was borne credible. But why was that? In my view, there have been mainly three, closely related, factors or principles at work: a clear and unambiguous institutional setting, the ECB's strong commitment to a high degree of transparency and its monetary policy strategy.

Clear mandate to an independent central bank

Let me start by making a few remarks on our mandate which is to deliver price stability. This mandate mirrors the mandates of a very large majority of the EU national central banks before 1999. It is enshrined in the Maastricht Treaty, which was signed by all governments of the European Union and ratified by all national parliaments, thereby reflecting a clear preference of the citizens of Europe for a stable currency. Consequently, our mandate to maintain price stability is included in an eminent place, under the "Union's objectives", in the draft Constitution just approved by the European Council last June. This clear assignment of responsibility to monetary policy has been indispensable in ensuring a high degree of credibility for our policy from the very outset.

But why is price stability an economically desirable objective? Well, price stability enhances the efficiency of the price mechanism in allocating resources. It is associated, in particular, with lower uncertainty and risk premia in financial markets. This facilitates financial transactions and ultimately implies lower medium and long-term interest rates, thereby fostering investment. Stable prices also prevent an ad hoc redistribution of wealth and income as a result of unexpected price developments, which in turn contributes to social cohesion. As both historical experience and a full body of academic research illustrates, maintaining price stability is a necessary condition for monetary policy to foster sustainable growth and job creation.

Independence

To ensure that we can fulfil our mandate effectively, the Treaty assigns considerable independence to the Eurosystem which consists of the ECB and the 12 national central banks of the EU Member States which have adopted the euro.

Today, there is a broad consensus among central bankers and economists that a high degree of independence allows the central bank to conduct its monetary policy in a consistent manner, to fulfil its mandate to guarantee price stability and thereby to gain and maintain a high degree of public confidence in its policy. Once the public and the markets are convinced of the central bank's commitment to preserve price stability, they will act - for example, in wage and price setting - in a way that facilitates the achievement of this goal. A virtuous cycle is created which is conducive to creating an environment of stable prices in which economic activity can flourish. At the same time central bank independence goes hand in hand with the need for transparency.

Transparency

In fact, today, transparency is the rule of the game. Striving for a high degree of transparency in monetary policy is widely acknowledged as a fundamental principle of efficient monetary policy. It includes the setting of clear benchmarks for accountability, which, in democratic societies, is the quid pro quo of independence. It also includes the announcement of unambiguous objectives to the public, a timely and comprehensive release of all pertinent information and the contents of monetary policy deliberations. In this sense, transparency does not only serve accountability, but also helps the markets to trace, to understand and broadly anticipate how monetary policy systematically reacts to observable data and indicators, thereby enhancing the credibility, predictability and effectiveness of monetary policy.

The ECB has played a leading role in this general trend towards greater transparency and openness. It has in fact set standards of transparency in the practice of monetary policy. Acknowledging that transparency ultimately is about public understanding of what we do and why, we have from the very beginning practised an open and transparent communication with market participants and the public at large. We have placed strong emphasis on transparency of the decision-making process, on the provision of timely and clear explanations of our economic diagnosis to the general public and market participants, and on accountability vis-à-vis the European Parliament.

This was an extremely important element for a new institution such as the ECB which was lacking a track record. The first and most important step towards a high degree of transparency was the explicit announcement of our monetary policy strategy in October 1998, well before we actually started conducting the single monetary policy in the euro area. It clearly stated the basic concepts driving our monetary policy and thus helped to reduce the acute uncertainty faced by market participants at that time.

As regards our communication policy, we have been from the very beginning very bold. In 1999 the state of the art of central banking communication was, with only very few exceptions, to display the diagnosis of the central bank with a delay of five or six weeks by publishing the minutes. As a rule, no timely and comprehensive explanation was given by issuing a detailed communiqué and by holding a press conference after the policy meeting.

In fact, the ECB was among the first central banks to give a real time detailed analysis and diagnosis and to organize regular press conferences and, to date, it still remains the only one doing so shortly after each of its monetary policy meetings. In our press conferences, we give a full and detailed explanation of our analysis and of the reasons underlying our policy decisions. The introductory statement opening our press conference consists of an extended summary of the deliberations of the Governing Council in which the situation is assessed and our diagnosis expressed. The press conference furthermore allows a transparent interaction with participants and, through them, with the full body of observers, savers and investors. All this wealth of information is provided in “real time”. In addition, the ECB’s Monthly Bulletin provides the public with the full set of detailed assessments and data underlying our policy decisions only a few days after they are taken. This demonstrates our strong will to be transparent.

Our commitment for transparency has been actually more and more acknowledged. This is reflected in the evidence of the first five and a half years (supported by recent empirical work) which suggests that we have been highly predictable in our decisions - at least as much as other very influential central banks. This also demonstrates that our monetary policy is well understood by external observers.

Monetary policy strategy

Let me now come to the third factor behind the success of the euro and the ECB, which lies at the heart of our monetary policy concept: the ECB’s monetary policy strategy. To devise the best possible monetary policy for the new currency, we aimed to build on the wisdom and the wealth of experience with the conduct of monetary policy that had been accumulated in the preceding decades by central banks and academic institutions in industrialised countries, in particular those forming the euro area.

The ECB’s definition of price stability

As I have emphasised above, the basis for our strategy is our mandate from the Treaty to maintain price stability as the primary objective of monetary policy. In order to make this mandate operational, the Governing Council of the ECB in October 1998 sharpened the focus by defining price stability in quantitative terms as the year-on-year increase in the Harmonised Index of Consumer Prices of below 2%. This public announcement was absolutely instrumental in preserving continuity at the moment of transition from the previous national currencies to the euro: the euro was given the very same definition of price stability as the one attributed to the most credible national currencies benefiting from the lowest market interest rates. We further clarified last year that, in the pursuit of price stability, the

ECB aims at inflation rates below but close to 2%, thereby preserving a sufficient safety margin against the risk of deflation.

There are great advantages of a clear, publicly announced quantitative definition of price stability: First, it is good for transparency, as everybody knows precisely what we are aiming at. Second, it is good for accountability, as the the public can judge whether and how we are achieving our own goals in comparison with the yardstick we made public. Finally, it is good for medium and long-term credibility, as inflationary expectations can be more easily anchored.

The medium-term orientation of the ECB's monetary policy

Ever since the announcement of its strategy in 1998 the ECB has also made it clear that price stability is to be maintained over the medium term. The medium-term orientation of the ECB's monetary policy strategy clarifies that the time horizon over which price stability has to be re-established needs to be tailored to the prevailing circumstances in the economy. By adapting the appropriate monetary policy horizon to the prevailing economic circumstances, the ECB makes an important contribution to avoiding unnecessary volatility in output and employment growth.

Moreover, our focus on the medium term embodies a commitment to avoid overly activist and ambitious attempts to fine-tune inflation outcomes. This also contributes to ensuring that expectations remain consistent with our declared policy objective over the medium term and helps the ECB to preserve its high degree of credibility,

Comprehensiveness of the analytical framework

We are all constantly bombarded with economic news. In order to protect itself against the risk of being swamped by latest indicators and to be able to deeply understand the main factors driving economic, monetary and financial developments, the central bank, in its daily operations, has to filter an enormous amount of information. It routinely seeks to define the state of the economy as new circumstances arise and evaluate their implications for the risks to price stability. This is a highly demanding exercise, because economic shocks do not come about with labels and are difficult to identify in real time. In addition, the economy is potentially always subject to several forms of structural change. As a consequence, it is clear for all central banks that no simple rules linking policy to one or two privileged indicators can substitute for an accurate examination of economic developments in all their complexities.

From the beginning, the ECB felt the need to adopt a conceptual framework that could help it sort through a wealth of potentially conflicting statistics, and organize the various pieces into a reliable road map for internal analysis and communication with the public. This required the adoption of a framework that concentrated more on picturing the economy as a large, complex and permanently evolving system.

As a consequence, in our analysis we incorporate all possible pertinent information, all relevant forecasts and modelling exercises, including private sector views. We are not dependent for our decisions on the mechanical result of an equation or a single set of equations or an algorithm. In a very complex world, where the complexity of reality cannot be adequately captured by any single model and where uncertainty is an important element to take into account in any decision, there is also need for judgement by the policymaking bodies in taking policy decisions, particularly in assessing the likelihood of certain hypothetical scenarios potentially materialising.

Specifically, we opted for a 'binocular' perspective over the economy, organised in an "economic analysis" and a "monetary analysis". This policy framework, which is well known as the 'two pillar approach', conveys the notion of a diversified analysis. Our economic analysis focuses on real activity and financial conditions to study shorter-run deviations of inflation from its long-term trends. However, we also complement this economic analysis with a monetary analysis, which places great emphasis on the longer-term trends of inflation.

Monetary analysis allows us to cross-check, from a medium to long-term perspective, the information stemming from the economic analysis. It constantly reminds the central bank of the fundamental principle that, while responding to economic developments as they unfold, it must never lose sight of the fact that, over sufficiently extended horizons, the rate of money growth must be consistent with its price stability objective. This cross-check ensures that all relevant information is taken into account in our assessment of the risks to price stability and that monetary policy has a nominal anchor beyond -

and even well beyond - the conventional projection horizon. It also induces and reinforces a firm sense of direction, discouraging policy agitation.

The need for structural reforms

However, good monetary policy alone is not sufficient to make monetary union a success. We have to be clear and realistic about what monetary policy can deliver and, even more importantly, what it cannot. Monetary policy, even though well-designed and implemented, cannot solve all Europe's economic problems. Appropriate structural reforms decisively implemented by national governments are vital for sustainable, non-inflationary growth of the euro area economy.

To increase the growth potential in Europe, structural reforms are needed for the euro area. This fact has long been recognised by EU policymakers, most notably by the European Council when it adopted the Lisbon Strategy four years ago to foster economic growth and drive job creation. Ambitious, well-designed and decisively implemented structural reforms in labour, product and capital markets will enhance the shock absorption capacity of the economy and the effectiveness of macroeconomic policies. In this respect, a convincing commitment to decisively implementing structural reforms and a credible communication of their economic benefits to the general public is crucial for raising consumer and investor confidence and, ultimately, growth and employment.

The new and stimulating challenge of enlargement

Let me now turn to the new and stimulating challenge of enlargement, which, in my view, offers a great opportunity for the European economy as a whole.

The enlargement of the European Union by ten countries from Central and Eastern Europe and the Mediterranean on 1st May this year was without any doubt a major milestone in the history of European integration. These countries together comprise a population of 75 million people which is about one fifth of that in the enlarged EU. While the economic weight of the new Member States is, at the current stage, less significant - their total GDP as a share of the existing members is about 5% (at market exchange rates, as compared with around 8% of the EU GDP when Spain and Portugal joined the EU in 1986), this will change in the future as their per-capita income levels are catching up with those in the rest of the EU.

What are the economic implications of EU enlargement for the European economy? The debate about the effects of enlargement is often dominated by concerns, such as the risk of mass migration from the new Member States, involving increased pressure on labour markets and welfare systems of the other Member States. In my view, the benefits that enlargement brings are often neglected in such discussions. I am convinced that EU enlargement is a win-win game for both the old and the new Member States, which will contribute positively to economic growth and welfare in the European Union as a whole. Let me explain why.

First of all, let me recall that over the past decade, the preparations for enlargement have already had a significant impact on the European economy, especially in terms of trade and financial integration between the new and the existing EU members. Profound structural changes in the new Member States in the past 15 years alongside with sub stantial progress towards the opening of markets early in the transition process (mainly through the implementation of the so-called Europe Agreements) have led to a tremendous increase in trade with the new Member States. Since 1995, the share of the current new Member States in the EU-15 exports and imports outside the EU (so-called extra-EU exports and imports) has increased by an impressive 50% to more than 13% and almost 12%, respectively. Likewise, impressive progress has been made during the past decade in terms of financial integration. Substantial inflows of foreign direct investment (FDI), constituting by far the largest share of total cumulative net private capital inflows to the new Member States, stand out in this respect and, in fact, FDI has been a key driver of productivity growth and export dynamics. Especially after the Russian crisis at the end of the 1990s, FDI flows from the EU-15 to the new Member States increased spectacularly and, according to the most recent data, the share of the current new Member States in the EU-15's total extra FDI outflows amounts to more than 12%.

The enlargement of the Single Market is beginning to strengthen the degree of competition as the accession of the new Member States increases the number of suppliers within the Single Market. In addition, an enlarged Single Market is enhancing the scope for economies of scale. These effects should lower prices and increase productivity, thereby contributing to an increase in the potential growth rate. Furthermore, the extension of the Single Market should increase the range and varieties of products available to producers and consumers.

However, these clear benefits do not come automatically. To what extent and how quickly they can be reaped depends critically on whether macroeconomic conditions are stable and the extent to which structural reforms are implemented.

From a central bank perspective, enlargement marks the beginning of a process which will lead to the integration of new Member States in the euro area, as these countries have no opt-out clause. This integration is taking place in a well-defined institutional framework and comprises several stages. The first phase for the new Member States is the period after EU accession and before joining the exchange rate mechanism (ERM II), which is a multilateral arrangement of fixed but adjustable exchange rates with a central parity and a standard fluctuation band of ±15% against the euro. The second phase starts with entry into ERM II and stretches all the way to the introduction of the euro. As you may know, three new Member States already entered ERM II in late June, while this step is still ahead for the other new Member States.

In this context, let me recall that there are no formal criteria to be met for entry into ERM II. However, successful and smooth participation requires that major policy adjustments - for example relating to fiscal policy and price liberalisation - are undertaken before joining the mechanism. Participation in ERM II can be an important means to anchor exchange rate and inflation expectations and to promote discipline. It can help orient macroeconomic policies to stability, while at the same time allowing for a degree of flexibility, if needed, through the wide standard fluctuation band and the possibility of adjusting the central parity.

Beyond membership in the ERM II lies the adoption of the euro. Joining the euro area is an irrevocable decision and thus a step of major importance requiring circumspection and careful preparation. All new Member States are expected to adopt the euro in due course once they are deemed to have fulfilled the conditions set by the Treaty. As in the past, each country will be assessed on its own merits and its particular situation, based on the principle of equal treatment. Therefore, no additional criteria for the adoption of the euro by the new Member States will be introduced, while at the same time there will be no relaxation of the criteria laid out in the Treaty, including the criteria concerning the sustainability of nominal convergence.

Concluding remarks

Let me conclude. As promised six years ago, our new currency has been firmly and credibly established as a stable currency. We have ensured a successful transition to the euro by transferring to the new currency the same degree of credibility as the one of the most credible national currencies that were merged into the euro. Thanks to the institutional setting of the Treaty and our monetary policy concept, the ECB was borne credible and has managed to maintain its high degree of credibility. Long-term interest rates have converged not to the average of pre-EMU levels but to those of the best previous benchmarks. Yet, there is no reason to be complacent. Ahead lie further challenges, most stimulating among them, the enlargement of the euro area.

I thank you for your attention.