Ms. Hämäläinen discusses monetary policy in EMU Discourse by the Governor of the Bank of Finland, Ms. Sirkka Hämäläinen, at the 1998 Penningpolitiskt Forum in Stockholm on 22/4/98.

The launch of the single monetary policy at the start of 1999, it now seems, will not bring any overwhelming shocks to the conduct or instrumental settings of monetary policy in the euro area.

The implementation of monetary policy is already much the same across the EU countries. Moreover, work on the detailed harmonization of monetary policy instruments or systems for payment transfers, needed for smoothing liquidity across the euro area, seems to be progressing well in the EU countries.

As regards the current monetary situation, exchange rates are close to their central rates in all the prospective EMU countries, led by market forces. Likewise, long-term interest rates have converged closely as a result of market expectations, and most of the key central bank rates - as well as short-term market rates - have moved into very close alignment. The background for this is of course the broad economic convergence of prospective EMU countries.

We would nonetheless be burying our heads in the sand if we were to overlook the fact that in some countries there is concern about a possible pickup in inflation, at the core countries' interest rate level, unless fiscal policy is tightened in these countries. These concerns are based on historical experience. However, it is very difficult to estimate how much expectations regarding EMU membership have also changed the behaviour within the inflation process.

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Decision-making in respect of the common monetary policy from the start of 1999 will take place within the Governing Council of the ECB, which will be made up of the governors of member-country central banks and the members of the Executive Board of the ECB. In the decision-making, each member will have one vote, which means that a representative of a small country will have the same voting power as a representative of the German or French central bank.

From the national central banks' perspective, it is important to note that it is only monetary policy decision-making that will shift to the European level. Other central bank functions, such as those concerning the stability of the financial markets and management of the currency supply, will remain at the national level as will all monetary policy operations and investment of foreign reserve assets. That is to say that the national central banks will continue to be national institutions, despite their membership in the European System of Central Banks.

The national central banks will be the shareholders in the ECB and the role of the governors of the national central banks, both in the system decisions and in monetary policymaking will be a central one. Influence in decision-making will be based first on the one-person-one-vote principle but above all on the expertise, professional skills and activeness of each central bank committee representative and eventually of the governor. This means that the national central banks will need to be able to carry out all the analysis and operations that have been required so far but, in addition to that, to expand their expertise and analyses to the euro-area level.

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One of the most important matters that the ECB's governing council will have to decide once it starts operating, is of course its monetary policy strategy. Credibility in monetary policy requires clear targets, so that the aims and objectives of the ECB can be explained *ex ante* and the implementation of those aims can be explained *ex post*. A clear target is an important means of achieving transparency and accountability, i.e. of communicating with the financial markets, policy-makers and the general public.

Defining the objective will not be an easy matter in the new circumstances. The EMI has sketched two alternative strategies for monetary policy in EMU, one based on monetary aggregates and the other on a direct inflation target. The former has historically worked well in Germany whereas the latter has produced good results in recent years in countries such as the United Kingdom, Sweden and Finland, where demand-for-money functions have not been stable enough for targeting purposes.

Although theoretically pure forms of the two strategies can be distinguished, in practice most central banks rely on elements of both. Thus, in the light of the internal decision-making process of the central bank, the strategic choice is not as crucial as it seems on the surface. Both strategies are forward-looking and both aim at the same ultimate goal - price stability.

A big challenge concerning the efficiency of the monetary policy is the credibility of the ESCB. Besides our lack of empirical evidence on the Europe-wide transmission mechanism, we have no evidence on the behaviour of the ECB, i.e. the ECB has no track record of its own. Fortunately however, the ECB need not be built up from scratch. First, it will inherit credibility from the present NCBs, which have all conducted monetary policies aimed at price stability and convergence in accord with the principles of the Maastricht Treaty. Secondly, its high degree of independence will give the ECB/ESCB a certain amount of institutional credibility right from the outset.

Recently, we have heard many voices, among political decision-makers, on the one hand, and academic researchers, on the other, who have emphasized the necessity of the accountability and transparency of the ECB.

Central banks and central bankers have since the onset of liberalization understood that one essential ingredient of monetary policymaking is openness. The more carefully the central bank explains its thinking to the financial markets, the more readily the markets' reactions to monetary policy measures can be predicted. That is to say, openness eases the conduct of monetary policy and strengthens its impact.

The role of national central banks in accountability and in promoting transparency within the ESCB will be that of communicator to national decision-makers, labour market participants and the general public regarding the analyses and views of the ECB, but also specifically regarding the domestic monetary policy transmission mechanism.

And the national central bank will need to continue analysing and forecasting its country's inflation path in the regime of the single monetary policy and, on this basis, present its outlook on possible national imbalances and national needs for corrective measures via other segments of economic policy, particularly fiscal policy.

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The single monetary policy will of course bring demanding challenges to peripheral countries whose industrial structures, behavioural modes and business cycles have previously diverged from those of the core countries.

As for Finland, thorough analyses have showed that external shocks have not been much bigger for Finland than for other countries. Instead, the domestic reactions in the economy and economic policies to these external shocks have greatly strengthened their effects.

In the short run, inflation rates may differ somewhat between EMU-member countries, but in the medium term harmonization is necessary. The real costs of this harmonization will be smaller when the common inflation target is more clearly credible and acknowledged and when all sectors are more clearly aiming at it also in the short run. We have seen clear improvement in this kind of awareness in Finland during the last few years, but of course it will be acid-tested during the current economic boom.

The corporate sector has used a substantial part of its profits from good years to improve its capital structure. It has built up a good buffer to be used in bad times and in covering losses without having to cut wages or reduce staff. Since wage developments are the most important cost factor for these company buffers, their creation is directly connected with wage restraint during economic booms.

The creation of buffers is just as important for the public sector as for the corporate sector, particularly in the central government. It is necessary to generate budget surpluses during economic booms, in order to have room for manoeuvre in bad times and to endure deficits in times of recession within the framework of the Stability and Growth Pact, and its 3 per cent of GDP limit.

Responsibility for curbing the booms and softening the recessions will shift in the EMU world to a much greater extent than before to fiscal policy. Here political decision-making will face strong pressures and challenges, both in Finland and in many other countries.

On the whole, it is good to keep in mind that a monetary union country with good central government finances will certainly have far more room for independent economic policy manoeuvring than will a non-monetary union country with a large central government deficit and debt.