

Mr Duisenberg reports on the current position and future prospects of the European System of Central Banks

Keynote address to the President of the European Central Bank, Dr W.F. Duisenberg, at a conference organised by the Royal Institute of International Affairs on European Economic and Monetary Union Markets and Politics under the euro in London on 27/11/98.

Introduction

Ladies and Gentlemen, I should like to express my appreciation at being invited to deliver a speech at this conference organised by the Royal Institute of International Affairs. It is a great pleasure for me to be here, in London, today.

The topic I am going to address relates to the current position and the future prospects of the European System of Central Banks. I feel that this topic provides me with an opportunity to deal with the objective of the ESCB and its contribution to the other policies in the Community. I will also briefly touch upon the decision-making in the ESCB, recall the main features of our monetary policy strategy and talk about our regard for openness and transparency. The final part of my talk will cover the views of the ESCB on recent economic developments and the future outlook for price stability in the euro area.

Independence, transparency and accountability

In the Maastricht Treaty the ESCB has been given an independent status. The reason is that politicians all over the world have come round to the view that monetary policy decisions taken with too close a political involvement tend to take too short a time horizon into consideration. The consequence is that in the longer term such decisions do not support sustainable gains in employment and income, but only lead to higher inflation. This view is confirmed by a host of economic research.

Independence, however, requires a clear mandate. The ESCB has such a mandate. Its primary objective is to maintain price stability. Without prejudice to the objective of price stability the ESCB will support the general economic policies in the Community. Price stability is not an end in itself: it creates the conditions in which other, higher-order, objectives can be reached. In particular, I share the deep concerns about the unacceptably high level of unemployment in Europe. The ESCB will do what it can to contribute to the solution of this problem. By maintaining price stability inflation expectations and interest rates can be kept at a low level. This creates a stability-oriented environment which fosters sustainable growth, a high level of employment, a fair society and better living standards. Moreover, in specific circumstances, if production, inflation and employment all move in the same direction, monetary policy can play some role in stabilising output and employment growth without endangering price stability. However, the contribution from monetary policy can generally be only limited. Given the structural nature of the unemployment problems the solution is to be found, above all, in structural reforms aimed at well-functioning labour and product markets.

An independent central bank does not only need a clear mandate. It has also to be an open and transparent institution, for at least three reasons. First, transparency enhances the effectiveness of monetary policy by creating the correct expectations on the part of economic agents. A predictable monetary policy contributes to achieving stable prices without significant adjustment costs and with the lowest interest rate possible. The second reason is that in a democratic society

the central bank has to account for its policies. Finally, transparency towards the outside world can also structure and discipline the internal debate inside the central bank.

Let me now turn to the ways and means of achieving transparency. As a first element the ESCB has defined a quantitative objective for price stability. It reads as follows: price stability is a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Although I do not consider deflation to be likely in the current environment, I may add that a situation of falling prices would not be consistent with price stability.

The Governing Council has made it clear that “price stability is to be maintained over the medium term”. The ESCB cannot be held accountable for short-run deviations from price stability, for example due to shocks in import prices or specific fiscal measures. A monetary policy reaction to short-run fluctuations in the price level would provide the wrong signals to the market and cause unnecessary interest rate volatility. In summary, the ESCB will react in an appropriate, measured and, when necessary, gradualist manner to economic disturbances that threaten price stability in the medium term, rather than in an abrupt way, in order to avoid unnecessary disruptions of the process of economic growth. That said, the ESCB will, whenever necessary, openly discuss and explain the sources of possible deviations from the quantitative definition of price stability.

In addition, let me remind you that by focusing on the HICP for the euro area, the ESCB makes it clear that it will base its decisions on monetary, economic and financial developments in the euro area as a whole. The single monetary policy has to take a euro area-wide perspective: it will not react to specific regional or national developments.

The institutional implication is that the ESCB should develop into a strong unity, with a strong centre and strong national central banks. It should become a truly European institution, with a truly European outlook. Of course, it may take some time to arrive where we ultimately want to be. We have to get used to thinking in euro area-wide terms. In the ECB Governing Council we are already “practising” that approaches and are making progress. I am confident that the ESCB will indeed act as a unity.

Transparency and openness will be apparent from the way in which the ESCB communicates with the public. The ESCB will regularly present its assessment of the monetary, economic and financial situation in the euro area and provide information about each specific monetary policy decision, be it a move in interest rates or an absence of change. This will notably be done by way of press releases, press conferences, publications and speeches. Press releases are made available immediately after the fortnightly meetings of the Governing Council and, as you may know, they always include a precise list of the decisions taken together with background information.

There will be a monthly press conference. Such a press conference will start with a detailed introductory statement, as has been the case so far, and these introductory statements will also be published immediately, without delay. In this statement the Vice-President and I will present the Governing Council’s view of the economic situation and the underlying arguments for its monetary policy decisions, followed by a question and answer session.

The publications of the ESCB will include, in particular, an ECB Bulletin each month as well as an Annual Report. As from 1999, a detailed analysis of the economic situation in the euro area will be presented in the monthly Bulletin. Thematic articles in this Bulletin will include in-depth analyses by the ECB on matters regarding the monetary policy of the ESCB and the economy of

the euro area. Further, you may also recall that, as required by its Statute, the ESCB will publish its consolidated balance sheet on a weekly basis.

My colleagues on the Executive Board of the ECB and I intend to be very active in giving speeches dealing with all issues of relevance for the conduct of monetary policy. I am convinced that the Governors of the national central banks will also play their role in this respect.

Since I am talking about the communication and external relations of the ESCB, I would like to underline that I am prepared to accept invitations to appear before the European Parliament at least four times a year to present the activities of the ESCB and the ECB's Annual Report. Finally, it should be noted that the ESCB would have a regular exchange of information and views with Ecofin. Representatives of the ECB will be invited to Ecofin meetings whenever issues of concern to monetary policy are discussed. A similar relationship will naturally also exist with the euro-11, whose meetings will generally be attended by the President of the ECB, whenever matters relevant to the ESCB are on the agenda.

Monetary policy strategy of the ESCB

We are now approaching the start of stage three of EMU. The decision-making bodies of the ECB have made a certain number of important decisions since the ESCB was established. As part of these decisions, the monetary policy strategy of the ESCB was recently announced and explained to the public. The selected stability-oriented strategy promotes as much continuity as possible with the existing strategies of national central banks in the EU. At the same time, its design is adapted to the unique situation of introducing a single currency in eleven countries, which may to a certain extent change economic behaviour. Therefore as much continuity as possible and as much change as required is the thrust of our strategy.

Our strategy consists of two pillars. The first is an important role for money and the second is a broad-based assessment of the outlook for price developments in the euro area. The main reason for assigning a prominent role to money is the empirically well-founded view that inflation, at least in the long run, is a monetary phenomenon. This simple and obvious observation led the Governing Council to announce a quantitative reference value for the growth of a broad measure of money. This choice will create a "nominal anchor" for monetary policy and therefore help stabilise private inflation expectations at longer horizons. The reference value will be derived in a manner that is clearly consistent with – and serves the achievement of – price stability. It will be constructed such that, in the absence of special factors or other distortions, deviations of monetary growth from the reference value will signal risks to price stability.

However, it has to be clear that the reference value is different from an intermediate monetary target, as the ESCB has not made any commitment to correct deviations of actual monetary growth from the reference value over the short term. In particular, it has been realistically recognised that the move to a single currency and ongoing financial innovations may generate fluctuations in the selected monetary aggregate which are not necessarily associated with inflationary or deflationary pressures. For this reason, it is important to continuously monitor the relevance of temporary factors or even structural changes in order to avoid a mechanistic policy reaction to deviations of the chosen monetary aggregate from the reference value. The results of this analysis and its impact on the ESCB's monetary policy decisions will be explained to the public.

Let me turn now to the second key element of the monetary policy strategy, the broad-based assessment of the risks to price stability. The information contained in monetary aggregates,

while of the utmost importance, will by no means constitute the whole of the “information set” in the hands of the ESCB. In parallel with the analysis of money growth, a wide range of economic and financial variables will be used to formulate an assessment of the outlook for price developments. The envisaged strategy will enable the ESCB to perform a crosscheck between the information coming from the evolution of monetary aggregates and those from other economic and financial indicators.

Recent economic developments and prospects

Let me turn to the current economic situation. The euro area experienced a strengthening of economic growth in 1997, to 2.5%, and a further acceleration has been anticipated for this year. The global environment has, of course, deteriorated in the meantime, but this has not so far had an observable impact on growth, which has, in any event, been increasingly led by domestic demand. Inflation has remained subdued and even fallen somewhat over the past year, partly as a result of the impact of weaker global demand on oil and commodity prices. However, the favourable pattern of inflation has also been supported by domestic factors, such as a very moderate development in unit labour costs and industrial producer prices.

Concerning recent price developments, HICP inflation for the euro area fell to 1.0% in September, due to a strong impact from food prices, but I would not want to read too much into this latest decline as some price components can be relatively volatile over short periods. More significantly, preliminary data suggest that various broad monetary aggregates for the euro area are increasing at between 3 and 5%, and thus do not appear to signal any strong incipient inflationary or deflationary pressures. We are in line with the consensus view that inflation in the euro area will rise moderately in 1999, but remain below 2%. I do not consider deflation to be a serious risk for price stability at present.

So far, despite the worsening of the global environment, euro area-wide activity has continued to expand at a fairly stable rate. At around 3%, annual real GDP growth was broadly unchanged in the first half of 1998 from the solid growth seen in the second half of 1997. Industrial production growth has slowed somewhat since the spring. More recent evidence, particularly that of the area-wide survey data, may also suggest a moderation in the pace of growth and further developments in these indicators will continue to be monitored closely. Area-wide growth should, however, be supported by a number of domestic factors. One factor supporting continued growth, particularly in private consumption, is the gradual improvement in labour market conditions. Moreover, the lowest short-term interest rates in the euro area currently stand at 3.3%, and several countries have cut interest rates towards this level recently as part of the process towards interest rate convergence. The process of convergence towards this level has been gradual, but should imply a reduction in the average short-term interest rate in the euro area of about 0.5 percentage point since July. Long-term rates also stand at low levels. And there has been a marked degree of exchange rate stability among countries participating in the euro. This is undoubtedly a welcome development from the standpoint of encouraging trade and investment. Thus, our assessment is similar to that of other international organisations, that – unless the international environment deteriorates further, which is not currently expected – growth will be somewhat weaker in 1999. Growth should, however, remain high enough to support continued employment creation and, assuming a recovery in the international environment, there should be a pick-up in growth in 2000. At the meetings in December the ECB Governing Council will again assess the outlook for economic and price developments.

Although the economic outlook may be less favourable than expected – let us say – half a year ago, I believe that the conditions for a successful launch of the euro are in place. You can be sure that the ESCB will do its utmost to make the euro a stable currency.