

Mr Noyer looks at some initial experiences with the euro

Speech by Christian Noyer, Vice-President of the European Central Bank, at the conference organised by the 'Gesprächskreis Nord' of the Friedrich-Ebert Foundation, in Hamburg on 8 March 1999

Thank you for the invitation to speak here on the occasion of this conference organised by the 'Gesprächskreis Nord' of the Friedrich-Ebert Foundation. It is only two months since the euro was launched. The introduction of the euro has been accomplished successfully and the enormous technical and logistical challenges arising during the early days of monetary union have been surmounted.

The start of monetary union proved to be a formidable operation. In spite of the operational difficulties and risks involved, the changeover passed without any serious incidents affecting the orderly conditions in the monetary system. The operations of the Eurosystem relating to the conversion of former national currencies into the euro went smoothly. There was no need to invoke any contingency measure, whether 'ordinary' or 'extraordinary'. The first main refinancing operations of the Eurosystem and the first regular longer-term refinancing operations were also settled successfully.

The introduction of the euro is unprecedented in European history. Although not yet embodied in the physical form of new banknotes and coins, there is no doubt that the new currency is set to play an important role in the euro area and beyond. The euro is present on all major financial markets around the globe. Currency trading is regularly carried out in euro. There are now shares denominated in euro on most European stock exchanges. Moreover, the euro has attracted new international bond issues as the currency of denomination. In some ways, the introduction of the euro may justify expectations of large efficiency gains in the international financial system. For EU citizens, two obvious gains will be, on the one hand, the reduction of transaction costs and, on the other, increased transparency, which facilitates price comparisons between different goods.

Monetary union offers a unique opportunity to establish and maintain price stability within the euro area. It promises a credible and lasting environment of price stability for almost 300 million people. Price stability is at the core of the 'stability culture' that we are seeking to establish throughout Europe. The Governing Council of the European Central Bank (ECB) is in charge of monetary policy decisions for the euro area. However, their implementation rests with the Eurosystem – that is the ECB and the 11 participating national central banks (NCBs). The Eurosystem has had the good fortune to assume authority over monetary policy in the euro area in an environment of price stability, owing to the successful process of disinflation and convergence within Europe over the past decade.

The Eurosystem's monetary policy strategy and the Treaty

The Treaty on European Union, commonly referred to as the Maastricht Treaty, assigns the European System of Central Banks (ESCB) the primary objective of maintaining price stability in the euro area. In order to give clear guidance for expectations of future price developments, the Governing Council has announced a quantitative definition of its primary objective. This clarifies how the Treaty's mandate is interpreted by the Governing Council and gives the public and the European Parliament clear guidance concerning its assessment of the success of the single monetary policy.

Price stability is to be maintained over the medium term. It has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. As the word 'increase' makes clear, deflation – that is, a persistent fall in the price level – would not be consistent with price stability. The annual rate of inflation, according to the most recent available data, of 0.8%, measured on this harmonised basis, is consistent with the definition of price stability. It should also be emphasised once again that the monetary policy is a single one and therefore

indivisible – by definition. Monetary policy decisions must be based on euro area-wide considerations, rather than national considerations. As simple as it may sound, those commentating on our monetary policy do not always appear to grasp this principle.

Monetary policy needs a forward-looking, medium-term orientation. Monetary policy should not and shall not react to every change in all the information that is produced on an almost daily basis. It would be over-ambitious and therefore risky to try to steer the economy in the short term. Fine-tuning would be more likely to lead to instability than stability. To maintain price stability, we have chosen a distinct monetary policy strategy, one that reflects the special circumstances that exist at present as well as those likely to prevail in the foreseeable future. The Eurosystem's stability-oriented monetary policy strategy ensures as much continuity as possible with the former strategies of the NCBs. At the same time, it gives due consideration to the unique situation which will prevail in the early years of monetary union. This strategy rests on two pillars. First, broad money is assigned a prominent role in the strategy. This is deemed to be important on account of the essentially monetary origins of inflation over the longer term. Second, a broadly based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole is carried out.

Monetary developments can reveal useful information about future price developments and thereby offer an important compass for the conduct of monetary policy. There is broad consensus that the development of the price level is a monetary phenomenon in the medium to long term. This takes into account the fact that monetary policy affects the price level only with variable, usually long and unpredictable time lags. It is not able to control all short-term movements in the price level. Furthermore, the historical experience of central banks in Europe and beyond demonstrates that it is important for the success of monetary policy to carry out a thorough analysis of monetary aggregates and the information they contain.

The Governing Council of the ECB has announced a quantitative reference value for the annual growth of the broad monetary aggregate M3. Substantial or prolonged deviations of current monetary growth from the reference value should, under normal circumstances, signal risks to price stability in the medium term. The choice of M3 as an aggregate is supported by empirical evidence regarding the long-run stability and leading indicator properties of this aggregate. Moreover, conceptual arguments pointed to the importance of including in the monetary aggregate those assets which have a high degree of substitutability with narrower definitions of money. Monitoring monetary developments also helps identify the nature of shocks hitting the economy. It thereby contributes to the assessment of overall economic developments.

Monetary policy does not react to deviations of monetary growth from the reference value in a 'mechanistic' way. In the first instance, such deviations will be thoroughly analysed to infer any signals which they may offer about the prospects for price developments. If the deviation points to a threat to price stability, monetary policy will react in a manner appropriate to counter this threat, rather than attempting to eliminate the deviation of monetary growth from the reference value in the short term.

The first reference value for M3 growth has been set at an annual rate of 4½%. This reference value is consistent with the maintenance of price stability over the medium term, while allowing for sustainable output growth and the trend decline in the velocity of circulation of M3. It will be reviewed in December 1999.

Although monetary data contain information which is important for monetary policy decision-making, monetary developments alone will clearly not constitute a complete summary of all the economic information necessary to take appropriate policy decisions. The Governing Council recognises that it is important, in parallel with the assessment of monetary growth, to look at a wide range of financial and other economic indicators, including economic forecasts. This systematic analysis of all other

relevant information about economic and financial conditions will ensure that the Governing Council is as well informed as possible when taking monetary policy decisions.

By fulfilling the unequivocal commitment of the Governing Council of the ECB to maintaining price stability in the euro area, we shall ensure that the single monetary policy contributes as much as possible to economic welfare in the broadest sense. At the same time, national fiscal authorities and general economic policies also have to demonstrate their commitment to the maintenance of price stability in the euro area over the medium term. In this context, the Stability and Growth Pact is a crucial element. Its aim is to encourage the pursuit of disciplined and sustainable fiscal policies in the euro area. In so doing, it can make a significant contribution to the establishment of favourable conditions for sustained economic growth and high employment in the medium to long term. It would be counterproductive if national fiscal policymakers did not continue their efforts in the light of the achievement of monetary union and the currently positive price outlook. I am not fully convinced that consolidation efforts are currently being undertaken with sufficient determination in all participating member states. The ECB cannot commit itself to take into account, in its overall assessment, any announced, but as yet uncertain, fiscal consolidation in some of the member states.

In line with its clear mandate, enshrined in the Treaty, and for sound economic reasons, the ECB has to decide which monetary stance best serves the maintenance of price stability over the medium term and then act accordingly. At the same time, the Treaty also emphasises the need for sound fiscal policies. This clear separation of responsibilities is both efficient and transparent. Monetary policy alone – even if it is well designed and fully successful in monitoring price stability – cannot solve Europe's economic problems. Appropriate structural reforms implemented by national governments are of the utmost importance. Much progress is required in this broad area. Moreover, responsible wage settlements in both the public and private sectors are necessary to reduce the unacceptably high level of unemployment in many parts of the euro area. Recent wage agreements in some parts of the euro area do not appear to be in the interest of higher employment.

Unemployment in the euro area is largely structural in origin. Implementing a monetary policy stance which is more lax than is justified by the monetary, financial and economic conditions will not solve this problem. Instead it will exacerbate it over the medium term, as inflation distorts investment and savings decisions, raises the risk premium in long-term interest rates and undermines the allocative efficiency of the price mechanism. Only effective structural policies that improve the flexibility and efficiency of labour and goods markets can reduce unemployment in a successful and lasting manner. I appreciate that such reforms are not always easy, not least because the benefits which they yield occur mainly in the medium to long term. However, they are essential. In those euro area member states that have taken up the challenge of structural reform, unemployment has fallen significantly. Other euro area member states are called upon to follow these examples: structural reform throughout the euro area is fundamental to the success of monetary union and to improving Europe's economic performance. In this respect, we may also be able to learn something by looking at the reasons behind strong employment growth and low unemployment in some of the member states of the European Union and in the United States, in particular regarding the flexibility of labour markets and incentives to create and accept new jobs.

Monetary policy decisions and the outlook for price stability

Since the start of this year the Governing Council has taken the following main monetary policy decisions. In December 1998 the Governing Council of the ECB announced that the level of interest on the main refinancing operation would be 3%. Since then, the Governing Council has kept this rate unchanged, as it has judged that doing so was serving best the maintenance of price stability.

The 12-month growth rate of the broad monetary aggregate M3 increased to 5.7% in January 1999 from 4.5% in December 1998. This increase is mainly due to rapidly growing overnight deposits, which account for around one-third of M3. The three-month moving average of M3 (for the period

from November 1998 to January 1999) increased to 4.9%, that is, slightly above the announced reference value of 4½% per annum. In view of the uncertainty relating to special factors pertaining to the changeover to the stage three environment and the introduction of the euro, the Governing Council does not view the recent acceleration in M3 as a signal of future inflationary pressures. However, monetary developments need to be monitored closely in the coming months.

With regard to the broadly based outlook for price developments and risks to price stability, new information on indicators of future price developments and economic activity in the euro area continue to provide mixed signals. Financial indicators such as the yield curve show that the spread between short-term and long-term interest rates has recently widened somewhat. This followed the decline in long-term interest rates in January to the lowest levels seen since the late 1940s. Nevertheless, conditions for investment at the start of monetary union are favourable. This relates in particular to the prevailing low interest rate level, which significantly reduces the costs of financing for investors.

Recent developments appear to have led to a reduction in some of the uncertainties surrounding the evolution of the world economy in 1999. This mainly relates to the strong performance of the US economy.

In the euro area the latest indicators confirm that those risks which were identified earlier have materialised to some extent. Real GDP growth in the euro area, which weakened in the fourth quarter of 1998 compared with the previous quarter, suggests that activity has been slowing down in recent months. This assessment is supported by other indicators, such as decreasing capacity utilisation and industrial confidence, both of which have been on a declining trend since mid-1998. By contrast, consumer confidence continues to present a favourable picture. The level of unemployment has remained more or less unchanged over the past few months.

Recent price developments are consistent with price stability. The latest data on the Harmonised Index of Consumer Prices show that the downward movement of inflation has stopped. The annual increase for February 1999 was reported to be 0.8%, the same as in the previous month. The current low inflation rate is partly due to substantial reductions in energy prices over the past half year, which have diminished somewhat very recently. Decreasing unit labour costs have also made a significant contribution.

In summary, the outlook for price stability remains favourable and, until now, we have not identified any significant upward or downward pressures on prices in the short term. On the downward side, the slowdown in the euro area economy is a cause for concern. On the upward side, increasing wage pressure and a relaxation of the fiscal stance could adversely affect the prospects for future price stability. Furthermore, recent exchange rate developments will also need to be monitored closely in view of their impact on prices.

In the absence of any strong upward or downward pressure on price developments, maintaining the current stance of monetary policy appeared justified. The Governing Council therefore decided last week that for the next two main refinancing operations the same conditions will apply as for the main refinancing operations settled earlier this year. This means they will be fixed rate tenders conducted at an interest rate of 3.0%. Interest rates applicable to the deposit facility and the marginal lending facility will continue to be 2.0% and 4.5% respectively. Of course, the Governing Council will continue to monitor all developments and reassess its monetary policy in its bi-weekly meetings.

The international dimension and the exchange rate

Let me now turn to the international dimension of the euro. As the representative of a monetary union which is comparable in size and importance with the United States, and as the central bank managing a currency that is likely to play a large and increasingly international role, the ECB will inevitably serve an important function in the international financial system. The ECB will embrace the implied

responsibility but, at the same time, it will have to be modest and realistic in its actions in the international arena. The ECB may be expected to contribute to international cooperation by adopting a positive attitude. The introduction of the euro could potentially simplify the process of international policy cooperation between the major economies, since the number of key players has been reduced. In particular, it should make this process more efficient by facilitating the exchange of views and the formulation of common understandings on economic and financial issues at the global level.

With regard to the Eurosystem's relationship with European Community institutions, the Treaty states that the President of the ECOFIN Council and a member of the European Commission may participate in the meetings of the Governing Council of the ECB, with the right to express their views but without voting power. Moreover, the ECB is required to disclose to the European Community institutions (the Council of the European Union, the European Commission and the European Parliament) an annual report on its monetary policy. The President of the ECB shall present this report to the ECOFIN Council and the European Parliament and also take part in the subsequent debate. As announced before, the President will attend the hearings at the European Parliament at least four times a year to discuss the activities of the Eurosystem. Finally, I should like to mention that the President of the ECB is also invited to the newly established informal Euro-11 Council meetings.

In the field of the international representation of the ECB, some decisions are still under consideration. Formal and informal agreements have already been reached with the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD) and in the context of the G7 and the G10. At the end of last year the IMF granted the ECB the status of observer. As you will be aware, full membership of the IMF is restricted to individual nations. Nevertheless, this observer status will allow the ECB to participate in the relevant work and assessments by the Fund of economic policies in the euro area and beyond.

The ECB stands ready to participate fully in, and contribute to, international policy discussions. It will, of course, offer expertise and exchange views when and where appropriate. However, the best contribution the ECB can make to a stable international monetary system, including stable exchange rates and smoothly functioning international capital markets, is to maintain price stability within the euro area. Fulfilling the mandate assigned to it by the Maastricht Treaty will help the ECB shoulder its international responsibilities.

The Eurosystem takes a neutral stance with regard to the international role of the euro. It neither promotes nor hinders the development of the euro as an international currency. The Eurosystem accepts the international role of the euro as it develops through market forces. There will be no deliberate policy of challenging third currencies. As yet it is too early to predict how long it will take for the euro to emerge as a truly international currency. Generally speaking, the commitment of the ECB to successfully fulfilling the mandate of the Treaty, that is to maintaining price stability in the euro area, will contribute to the international role of the euro.

Allow me to say a few words on certain proposals made in the ongoing public debate, which might suggest that the focus of monetary policy should be shifted towards objectives other than price stability. Some suggestions seem to imply that the Eurosystem should react more or less automatically to exchange rate movements or other specific variables. Just as a doctor cannot stop a fever by holding the thermometer under cold water without an appropriate therapy, monetary policy cannot stabilise exchange rates if pressure occurs as a result of diverging cyclical positions, market fundamentals or structural and fiscal policies. Therefore, we deliberately excluded any kind of explicit or implicit exchange rate objectives or targets from our monetary policy strategy.

Nevertheless, the Eurosystem's stability-oriented monetary policy strategy takes into account the external value of the euro as one, potentially important, determinant of the outlook for price stability. If its development poses a threat to price stability in the euro area, this threat will be assessed. However, all other factors that impart information on price developments will always be taken into

account before a decision will be taken. Obviously, if a strong and abrupt appreciation of the euro were to occur, this would lead, all other things being equal, to downward pressures on price developments. In such a situation, there would be more reason to lower the ECB's interest rates, which might then, in turn, help counteract part of the prior exchange rate movement.

But setting exchange rate targets might, for example, imply that a central bank has to increase its interest rates in a situation of weak demand and downward pressures on prices, just because of a depreciation in the exchange rate. I think you will agree with me that this might not be appropriate. According to the Maastricht Treaty, the ECOFIN Council may formulate so-called general orientations for the exchange rate policy, which shall be without prejudice to the primary objective of maintaining price stability. The ECOFIN Council has agreed to issue so-called orientations for exchange rate policy only in exceptional circumstances, such as a clear and sustained misalignment of the euro. In addition, we are not currently participating in a formal exchange rate arrangement with third countries outside the EU, for instance the United States, and we consider it very unlikely that this situation will change.

Accountability and transparency of the monetary policy of the Eurosystem

Let me turn to the issues of accountability and transparency. In general, central banks should be open, transparent and accountable, reporting extensively to the public on their activities. The issue of the transparency of monetary policy is very important, given that the Eurosystem is a new institution and the public is not accustomed to evaluating its behaviour. Moreover, by communicating clearly with the public, the Eurosystem reinforces its credibility and signals that its monetary policy is appropriately geared to the maintenance of price stability. In this regard, the Eurosystem's approach bears comparison with the 'best practices' of any other central bank. Accountability is the counterpart to independence. We should also be clear that the independence of the ECB does not exclude a dialogue with political authorities.

The monetary policy of the Eurosystem will be held accountable for reaching its overriding objective of maintaining price stability. The Eurosystem is open, transparent and, above all, accountable for its performance. As part of its communication strategy, the Governing Council of the ECB regularly informs the public about its assessment of the monetary, economic and financial situation in the euro area and about specific monetary policy decisions. Moreover, since January 1999 the ECB has been publishing a Monthly Bulletin containing additional and detailed analysis of the economic situation in the euro area.

In some areas the Eurosystem has gone beyond the Treaty requirements. The Governing Council meets every fortnight. The first meeting in every month is immediately followed by a press conference, at which the President of the ECB and I explain the decisions taken by the Governing Council. On that occasion, the 'Introductory Statement of the President' of the Eurosystem is released to the press. This is similar to what other central banks call minutes. We are convinced that this very prompt delivery of information serves the interests of the public in an optimal way. Few central banks follow a policy of publishing their minutes almost immediately after the meeting of their governing body. We are also convinced that it is in the public interest for the view of the Governing Council as a whole to be presented, rather than the views of individual members.

Concluding remarks

Let me finally urge caution with regard to any excessively high expectations at the start. History also shows that the full benefits of changes as substantial as the introduction of the euro may come neither immediately nor automatically. It normally takes some time to adapt to a new situation. Most importantly, efficiency and welfare gains will require structural reforms of labour and goods markets to improve flexibility. One can only hope that the euro is working as a catalyst for such change.