Mr Noyer reviews first experiences with the euro

Speech delivered by the Vice-President of the European Central Bank, Mr Christian Noyer, at the conference organised by Swedback in Stockholm on 26 May 1999.

I should like to start by thanking you for your kind invitation to speak here on the occasion of this conference organised by Swedbank. It is some five months now 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 overcome. The first months of the euro have been successful in both political and operational terms. With the introduction of the euro, European integration has taken a large step forward as the new millennium approaches.

The euro plays an important role in the euro area and beyond. Just after its launch in January, the euro already featured on all major financial markets around the globe. Currency trading is regularly carried out in euro and shares are 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 overall efficiency gains. For citizens living in the euro area, two obvious gains will be the reduction of transaction costs and increased transparency across countries, as price comparisons between goods sold in different countries are made easier.

The Governing Council of the ECB is the central decision-making body in charge of monetary policy for the euro area. The Treaty on European Union – the Maastricht Treaty – assigns the ESCB the primary objective of maintaining price stability in the euro area. The implementation of monetary policy decisions taken centrally by the Governing Council rests with the Eurosystem, comprising the ECB and the national central banks (NCBs) of the member states which have adopted the euro in stage three of economic and monetary union. The respective operational tasks are to a large extent carried out in a decentralised manner by the NCBs.

For the euro to become a success story as the single currency for around 300 million people, the confidence of European citizens in the stability of the new currency and in the Eurosystem is crucial. You would probably agree that the Eurosystem has already achieved a lot in terms of building up credibility and gaining a sound reputation in financial markets for its monetary policy in its early days. This will certainly facilitate the establishment of a stability culture throughout Europe. The foundation of this stability culture is a broad consensus among Europeans that the maintenance of price stability is of the utmost importance and is conducive to the achievement of other objectives such as high employment.

Monetary policy and other policy areas

By maintaining price stability in the euro area, we will ensure that the single monetary policy contributes as much as possible to economic growth and high employment. 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. In this context, the Stability and Growth Pact adopted in 1997 is a crucial element. Its aim is to encourage the pursuit of disciplined and sustainable fiscal policies for the participating member states and prospective members. 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 term. Moreover, sound fiscal policies facilitate the task of monetary policy to maintain price stability. It would be counterproductive if national fiscal policymakers were not to continue to work towards a budgetary situation which is close to balance or in surplus in the light of the achievement of monetary union and the positive price outlook for the euro area.

In this connection please allow me to briefly address the matter of calls for closer coordination between monetary policy and fiscal policies. Any form of ex ante coordination that, for example, would commit the monetary policy of the ECB to move its interest rates in a certain way in response to specific action or plans of other policymakers would provide the wrong impetus for the conduct of sound macroeconomic policies and would not be efficient. This does not, however, exclude a constructive dialogue between the Eurosystem and government authorities which clearly respects the independence of the ECB.

In line with its clear mandate, enshrined in the Treaty establishing the European Communities, and for sound economic reasons, the ECB has to decide which monetary policy 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. Obviously, monetary policy alone cannot solve Europe's economic problems such as the present intolerably high level of unemployment. Appropriate structural reforms implemented by national governments are of the utmost importance and much progress is required in this broad area. Moderate wage settlements in both the public and private sectors would, of course, contribute to reducing the high level of unemployment in many parts of the euro area. In this context, let me remark that recent wage agreements in some parts of the euro area do not appear to be in line with the need to encourage higher employment.

The Eurosystem's monetary policy strategy

With regard to the Eurosystem's monetary policy strategy, I should like to emphasise that the euro area monetary policy is a single one and therefore indivisible – by definition. Monetary policy decisions must be based on area-wide rather than national considerations and hence on area-wide indicators. Monetary policy has to be transparent so as to stabilise public expectations of future price developments. In order to clarify how we interpret the mandate conferred on the ECB by the Treaty, the Governing Council has announced a quantitative definition of its primary objective.

Price stability has been defined as a year-on-year increase in the harmonised index of consumer prices (HICP) for the euro area of below 2%. This has to be maintained over the medium term. As the wording 'increase' makes clear, deflation – that is, a persistent fall in the price level – would not be consistent with price stability. It would not be possible for us to announce where exactly we would draw the dividing line between price stability and deflation. This is partly for reasons that have been described as the measurement bias in consumer price indices. For the United States it was estimated that measured consumer prices tend to slightly overestimate actual inflation. A bias may also exist for the euro area HICP, although its exact magnitude is as yet unknown and needs to be explored further.

To maintain price stability, the Governing Council has chosen a stability-oriented monetary policy strategy. The chosen strategy is forward-looking in nature and also ensures as much continuity as possible with the former strategies of the NCBs. In this respect and with regard to the overriding objective to maintain price stability in an environment of flexible exchange rates, our strategy is broadly similar to that of Sveriges Riksbank, although there are important differences. In particular, the Riksbank follows a direct inflation targeting strategy in which monetary policy is almost exclusively guided by inflation forecasts of about two years ahead. In contrast, the Eurosystem relies on two pillars, thereby focusing on the medium term, and does not give such a predominant role to inflation forecasts as the Riksbank.

In our view, the Riksbank has achieved high standards with regard to transparency and accountability, as is for example evidenced by its comprehensive quarterly inflation report. In more recent years, the Riksbank has enjoyed a fair measure of success in gaining control over domestic price developments, as supported by its strong performance in fighting inflation, and in overcoming a deep recession in the early 1990s. Its track record also demonstrates that price stability in Sweden was given a high priority long before this was formally recognised by an amendment to the Riksbank Act at the start of 1999.

The Eurosystem's stability-oriented monetary policy strategy rests on two pillars, which are both important when the Governing Council discusses monetary, financial and economic developments at its biweekly meetings. The first pillar, which is a prominent role for money, takes into account the essentially monetary origins of inflation over the medium to long term. It recognises that empirical studies show a stable long-term relationship between money and prices in the euro area. Therefore, in the euro area, monetary developments constitute an important guide for the conduct of monetary policy and it is essential to analyse and monitor the development of monetary aggregates closely. The ECB has announced a quantitative reference value for broad monetary growth as measured by M3, the first reference value for M3 growth being set at an annual rate of 4.5%. This reference value is consistent with the maintenance of price stability over the medium term, while allowing for sustainable output growth and assuming a trend decline in the velocity of circulation of M3. In setting the reference value for monetary growth, the Governing Council emphasised its medium-term orientation. Substantial or prolonged deviations of current monetary growth from the reference value will normally signal risks to price stability in the medium term.

The ECB does not intend to react to deviations of monetary growth from the reference value in a mechanistic way. In the first instance, such deviations are analysed thoroughly to infer any signals which they may give about the prospects for price developments. If the deviation points to a threat to price stability, monetary policy has to react in a manner appropriate to counter this threat.

Although monetary data contain information which is important for monetary policy decision-making, monetary developments alone clearly do not constitute a complete summary of all the economic information necessary for appropriate policy decisions to be taken. Thus the Governing Council emphasises 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. The second pillar of the Eurosystem's strategy therefore consists of a broadly based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole. This broadly based assessment takes into account, inter alia, the information provided by wage developments, exchange rates, fiscal indicators, real economic activity, and asset and commodity prices. Forecasts of economic activity and prices in the euro area can certainly also contribute to the success of an appropriately forward-looking monetary policy. Thus we take into account forecasts available from international organisations such as the IMF and the OECD as well as internal forecasts.

We are aware that forecasts have to be interpreted with great caution. Given behavioural, institutional and structural uncertainties, forecasting price and other developments in the euro area is inevitably difficult. Moreover, a forecast cannot encompass all the indicator variables that are important for monetary policy. Nor can it always incorporate indicators in a timely manner. Furthermore, by the time the forecast has been finalised, the original assumptions may have become less realistic, requiring a careful interpretation of the results. Therefore, a thorough analysis of individual indicator variables plays an important role in our monetary policy strategy, in addition to any role that these variables may have in the forecast.

Within the stability-oriented monetary policy strategy, the Eurosystem also takes into account the external value of the euro as an important determinant of the outlook for price stability. If exchange rate developments pose a significant threat to price stability in the euro area, all other things being equal, monetary policy will have to respond. Of course, all other factors that impart information on price developments will also be taken into account before an interest rate decision is taken.

Monetary policy decisions and the outlook for price stability

In December 1998 the Governing Council announced that the interest rate on the main refinancing operation would be 3%. In the first quarter of 1999 the Governing Council kept this rate unchanged. After an in-depth review of recent monetary, financial and economic developments, the Governing Council decided at its meeting on 8 April to set the interest rate for the ECB's main refinancing operations at 2.5%. In addition, the interest rate on the marginal lending facility was lowered to 3.5% and the interest rate on the deposit facility to 1.5%. These rates were left unchanged at the meeting of the Governing Council last week. The decision to lower interest rates taken at the first meeting in April has to be seen in the context of the stability-oriented strategy. The decision has thus been taken from a forward-looking perspective, focusing on the medium-term trends in inflation and the compatibility of these trends with the Eurosystem's definition of price stability. By adhering to this strategy, the Eurosystem's monetary policy contributes to creating the economic conditions which are essential to exploiting the considerable growth potential of the euro area and to reducing uncertainty about future economic developments.

I should like to take this opportunity to explain the current assessment, which is in line with the Governing Council's expectations at the beginning of April. With regard to the first pillar of the Eurosystem's monetary policy strategy, monetary growth cannot be seen as signalling upcoming inflationary pressures at this stage. Since the beginning of this year, the three-month moving average of M3 growth has been close to the reference value of 4.5%. For the period from January to March 1999 the average growth rate increased somewhat to 5.2%. This observation may, however, have been affected by special factors prevailing at the start of stage three. Therefore, in its current assessment the Governing Council does not regard current monetary trends as constituting a signal of future inflationary pressures.

With regard to the second pillar of the Eurosystem's monetary policy strategy, the broadly based outlook for price developments and risks to price stability and various indicators of future price developments and economic activity in the euro area indicate a favourable outlook for price stability. Financial indicators such as the very low level of long-term interest rates point to low inflation expectations and the credibility of monetary policy. Following the cut in short-term interest rates, long-term rates decreased somewhat initially, which confirms that the market considered the cut in interest rates by the ECB to be appropriate. More recently these rates have risen somewhat, mainly as a reflex to the strong increase in long-term interest rates in the United States.

Regarding economic activity in the euro area, data available for the first two months of 1999 do not yet reveal evidence of a rebound in economic growth. Labour market indicators show signs of a somewhat decelerating level of employment growth towards the end of 1998. Meanwhile, preliminary April figures from the European Commission on confidence indicators point towards some first signs of an improvement in industrial confidence.

Recent price trends have been consistent with price stability. Inflation for the euro area as measured by the harmonised index of consumer prices (HICP) has been close to 1% since the fourth quarter of 1998. As has been emphasised on previous occasions, the current low inflation rates are to some extent the reflection of the large fall in energy prices during 1998. HICP data for March 1999 show an annual increase of 1%. The slight increase relative to January and February reflects the fact that goods prices are subject to some upward movement in the short term owing to the reversal in energy price trends expected by the Governing Council at the beginning of April. However, the effects of changes in energy prices on rates of HICP increase may only be of a temporary nature. More lasting effects on future consumer prices normally come from changes in the overall monetary and economic situation.

To sum up, weighing all the relevant indicators and adopting a forward-looking and medium-term perspective, the Governing Council regards the current level of ECB interest rates as appropriate with a view to maintaining the outlook for continued price stability.

Aspects of the Eurosystem’s communication policy

The Treaty acknowledges that it is important in a democratic constitution for an independent central bank to be open, transparent and clear about the reasoning underlying its actions. Therefore, a number of reporting obligations exist for the ECB which aim at making the ECB accountable for its performance. Moreover, by communicating clearly with the public, the Eurosystem reinforces its credibility. In this regard, the Eurosystem’s approach bears comparison with the best practices of any other central bank.

In practice the ECB has committed itself to exceeding the stringent requirements of the Treaty concerning transparency and accountability. For example, the ECB releases each month a bulletin providing detailed background information regarding the current assessment of the economic outlook. At the same time, with the more extended editions of the bulletin in March, June, September and December, we fulfil the Treaty requirement to publish a quarterly report. For the benefit of the general public, the ECB issues regular press releases and an introductory statement by the President, which is released immediately after the first Governing Council meeting each month. Furthermore, the ECB submits an annual report on its activities to the European Community institutions (the Council of the European Union, the European Commission and the European Parliament).

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. The President of the ECB attends hearings at the European Parliament at least four times a year to discuss the activities of the Eurosystem and is also invited to attend the informal euro-11 Council meetings. I should like to stress that the participation of the President in these meetings serves the purpose of exchanging information and views, while fully respecting the independence of the Eurosystem.

In the field of the international representation of the ECB, formal and informal agreements have been reached with the IMF and the OECD and in the context of the G7 and the G10. At the end of last year the IMF granted the ECB observer status, full membership being restricted to individual nations. Nevertheless, this observer status will allow the ECB to participate in the relevant work and assessments by the IMF of economic policies in the euro area and beyond.

The international role of the euro

Clearly, the introduction of the euro has had important implications for international capital markets. This has been the case not just because a number of currencies replaced by the euro played an important international role in the past but also because the euro has become the currency of an economic area which roughly equals the United States in terms of economic size and external trade, and which has the world's second largest capital markets.

Let me emphasise at this juncture that the Eurosystem has no exchange rate target vis-à-vis other major currencies. We are also not participating in a formal exchange rate arrangement with third countries outside the EU, for instance with the United States, and we believe that this situation will continue in the future. It is important to mention that according to the Treaty the single exchange rate policy has to respect the primary objective of price stability.

As the representative of a large economic area, the Eurosystem can best meet its overriding objective to maintain price stability in the euro area if it is not constrained by an exchange rate target. However, for smaller, very open economies, setting an exchange rate target may be a very reasonable decision. Against this background the ERM II exchange rate mechanism was created for those member states which have not yet joined monetary union but are willing to do so in the near future. Experience with the European Monetary System (EMS), the predecessor of ERM II, has shown that participation in a system of this kind may facilitate the fulfilment of other convergence criteria. The new exchange rate mechanism may play a similar role. In this context, we should certainly wish to acknowledge the efforts which Sweden is making to achieve sustainable convergence with the euro area. We hope that the success of the euro in its early months will help to convince the Swedish population of the benefits of early participation in monetary union. Clearly, a decision to join ERM II would be important for fulfilling the convergence criterion of exchange rate stability and would help to smooth the transition to participation in the euro area.

In recent months the external value of the euro has been influenced by the market view of the economic developments in the euro area relative to the United States. More recently other factors had an impact on the exchange rate of the euro vis-à-vis the dollar, in particular the conflict in Kosovo. From the beginning of the year to mid-May, the euro weakened against the dollar by about 10%. In nominal terms, measured against a trade-weighted basket of the currencies of the 15 most important trading partners of the euro area, the euro has weakened significantly less, i.e. by about 6% since its launch. However, rather than focusing on very short-term developments, one should look at long-term evolution. In that respect, it has to be observed that the current exchange rate of the euro against the dollar is not so very different from the levels observed in the first three quarters of 1998.

Clearly, some variability is typical for the bilateral exchange rate vis-à-vis the US dollar. Market expectations about future cyclical developments and the course of monetary and fiscal policy in the United States and Europe play a role in explaining exchange rate volatility. It is widely recognised that in the medium to long term exchange rates follow a path determined by fundamental factors such as price and economic developments. In this context, it should be pointed out that recent exchange rate developments have as yet not indicated any risk for future price stability. Moreover, internal price stability should serve as an anchor for the development of the euro's external value in the medium term. Indeed, a stability-oriented monetary policy strategy protecting the purchasing power of the euro is the basis of a solid and stable currency over the medium term.

Maintaining price stability in the euro area also promotes credibility and thereby enhances the international role of the euro. The Eurosystem neither promotes nor hinders the development of the euro as an international currency. We consider that the international role of the euro should develop through the interaction of market forces. As yet it is too early to predict how long it will take for the euro to be considered as a truly international currency similar to the US dollar.

Clearly, the disappearance of 11 national currencies and the introduction of the euro as a major international currency had an immediate impact on the turnover and focus of attention in the global foreign exchange markets. This has been reflected, for example, in rather active and liquid euro/dollar trading in the foreign exchange market since the launch of the new currency. However, there are also indications that the euro has further potential to grow in other markets as the surprisingly slow development of euro/yen trading suggests.

The euro can also be expected to become an attractive currency for the investment of official reserves.

One of the key elements to further international portfolio diversification in favour of the euro is the creation of a large, liquid and integrated capital market in Europe that began with the launch of the euro. For short-term instruments, we are now dealing with a broad and liquid European money market that ensures very similar short-term interest rates for comparable instruments and credit risks. The development of this market has been strengthened by the Eurosystem's operational framework of open market operations, which is mainly based on reverse transactions, and the implementation of the new TARGET real-time gross settlement system in participating countries. At the longer end of the maturity spectrum, market integration was jumpstarted by the redenomination of outstanding government debt in euro and by the convergence of interest rates to narrower spreads following the elimination of the exchange rate risk. The elimination of this main risk will also foster the development of uniform market standards so that government bonds in the euro area will become rather close substitutes, creating a large and liquid bond market. Obviously, this requires sound and sustainable budgetary policies that ensure that credit risk spreads remain small.

Concluding remarks

Following a remarkable period of disinflation in most member states, the Eurosystem has had the good fortune to commence its operations in an environment of price stability. The success enjoyed by the euro in its first five months can be certainly attributed to a number of factors. Above all, the successful efforts of member states made possible a smooth changeover to the euro. The independence of the ECB and the clear mandate to maintain price stability were crucial for ensuring a high degree of credibility of the Eurosystem's monetary policy. As a final observation, I should simply like to mention that without the positive echo of financial markets and the permanent support of banks and financial institutions, a single currency in Europe could not have become a reality.