

Mr Noyer considers some consequences of globalisation for policymakers and the conduct of monetary policy

Introductory statement by Mr Christian Noyer, Vice-President of the European Central Bank, at the Fifth International Financial and Economic Forum: "Impact of globally liberalised capital markets", organised by IFW in Vienna on 11 November 1999.

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Introduction

Globalisation - understood as the internationalisation of political, social and economic affairs - affects both policymaking as well as our daily lives. The idea that we live in a "global village" is perhaps suggested by the fact that on our satellite television we can immediately watch events which are unfolding in very distant places. Or perhaps it is a subtler feeling gradually coming into our minds while we fill in an e-mail order to buy a new book listed in a far-off country.

However, there is ample evidence that the world we live in is not yet the fully globally integrated system often portrayed in economics textbooks. For example, the prices of tradable goods in different countries expressed in a common currency sometimes converge to a common level rather slowly. Asset portfolios tend to exhibit "home bias". Thus, in a fundamental sense, it seems that there is "some" globalisation yet to come.

Nevertheless, the internationalisation of markets, in particular those in the financial sphere, has important implications for the conduct of monetary policy. As international investors thoroughly scrutinise national economic and political developments, unexpected changes in the latter, or "news", may trigger the reassessment of investment strategies. These, in turn, may have an impact on exchange rates, interest rates and equity prices.

Against this background it is understandable that it sometimes appears more convenient to blame "foreign speculators" or "global markets" for all kinds of economic and social problems, rather than acknowledge their domestic origin, which quite often lies in unsustainable domestic economic policies and a lack of structural reforms.

Of course, it goes without saying that financial markets can also be wrong in their assessment of the fundamental determinants of asset prices. International investors can sometimes be influenced by fads and self-fulfilling beliefs which drive prices away from their fundamental determinants. Asset price "bubbles" can emerge. However, it is very difficult for policymakers to identify such misalignments and bubbles. Moreover, increased volatility of financial markets and perceived misalignments are often related to fundamental factors such as policy failures and to a lack of transparency and clarity in policymaking.

In the remainder of my presentation I shall focus on monetary policymaking in a *global market*. The subject is naturally too vast to be fully covered in my introductory statement. Thus, I shall focus my attention on two issues which I think are relevant to our discussion today. First, I shall mention some of the consequences of globalisation for policymakers. Second, I shall explain why I think that the monetary policy strategy of the European Central Bank is well designed to face the challenges stemming from globalisation.

Some consequences of globalisation for policymakers

With regard to the first issue, let me emphasise that I do not believe that globalisation has eliminated policymakers' influence over domestic political, social and economic developments, particularly in larger industrialised countries (or areas). On the contrary, the fact that people and capital can move more freely and quickly across borders makes the consequences of national policy decisions for the

respective economies much more immediate and visible. Obviously, this makes national policymaking and its presentation to the public more demanding.

Naturally, there is a disciplinary effect which comes from globalisation but this does not necessarily run counter to the national interest. The influence of domestic policymakers can be used for good or evil. Globalisation improves the incentives for national politicians to implement good policies, such as structural reforms, which increase the flexibility of the economy. This is demanded by the Treaty establishing the European Community, which requires Member States and the ESCB to “act in accordance with the principles of an open-market economy with free competition”. These policies will contribute to improved growth and employment perspectives. I believe in the idea that all nations gain from trade, including trade in financial assets. Notwithstanding possible imperfections in the financial markets, international capital market integration can yield considerable benefits. However, it is important to stress that without flexible markets, countries will not be able to reap the full benefits of globalisation.

Moreover, it is well known that national authorities would face an impossible task if they had to reconcile in a sustained manner the objectives of what has been called the “inconsistent quartet” of (1) free trade, (2) complete international capital mobility, (3) fixed or managed exchange rates and (4) national autonomy in the conduct of monetary policy. The painful lesson to be learned from economic theory and historical experience is that these four elements cannot coexist, and that at least one will have to give way. This is of course one of the major insights which Robert Mundell, this year’s Nobel prize winner, taught us more than 30 years ago.

Globalisation also implies that certain types of policy measures become less effective. This refers in particular to all regulations which can easily be circumvented by the private sector by redirecting business activities to foreign countries or by transferring funds abroad.

The Eurosystem took this into account in elaborating its operational framework, which was set up in line with the market principle. For example, there is no facility which explicitly or implicitly subsidises counterparties. Moreover, the remuneration of reserve requirements eliminates the danger that domestic residents will hold deposits outside the euro area in order to avoid the costs related to non-remuneration.

The monetary policy strategy of the Eurosystem and globalisation

As regards the conduct of monetary policy, I think that, in particular in large economies, central banks continue to be able to influence liquidity conditions and thus short-term market rates, irrespective of globalisation and of whether the currency is widely used outside the currency area concerned (or national boundaries). Monetary policy - by adjusting short-term interest rates - will therefore still be in a position to maintain price stability in the respective currency area. However, globalisation sometimes makes it more difficult to analyse monetary policy indicators and to investigate and understand the transmission mechanism.

An important precondition for monetary policy to remain effective in a globalised environment is a high degree of credibility. If international markets lose confidence in monetary policy, the negative implications for the domestic economy are likely to be significantly larger in an environment of closely integrated financial markets. The need to remain credible in a globalised market requires a convincing strategy and transparent communication. In this respect the Eurosystem is well equipped, as I shall now explain.

The primary objective of the Eurosystem is to maintain price stability in the euro area, as laid down in the Treaty establishing the European Community. To fulfil its mandate, the Governing Council of the European Central Bank has adopted a monetary policy strategy which is neither conventional monetary targeting, nor direct inflation targeting, nor a simple mixture of the two. Rather the Eurosystem’s monetary policy strategy is new, reflecting the unique circumstances surrounding the birth of the euro.

The adoption of the single monetary policy by 11 European countries marked a significant shift of regime. Under these circumstances, the uncertainty facing the Eurosystem in respect of the indicator properties of monetary, financial and other economic variables for future price developments, and with regard to the reaction of the private sector to monetary policy measures, is greater than has typically been the case in national contexts in the past.

Against this background, the Eurosystem explicitly eschews placing reliance solely on a single indicator or intermediate target for the conduct of monetary policy. The strategy aims to identify those economic disturbances which threaten price stability and to prompt a monetary policy response which is appropriate for maintaining price stability taking into account both the prevailing economic circumstances and the nature of the threat.

Given that the Eurosystem's strategy has been designed in this way, globalisation and the uncertainties and changes which it implies will not impair the ability of the Eurosystem to maintain price stability. The Eurosystem's monetary policy is based on a clear framework which is able to cope with the possible impact of external developments on the economic situation in the euro area. In particular, one of the strengths of this strategy is that it allows for all relevant indicators to be taken into account over time.

By assigning overriding priority to the maintenance of price stability, the Eurosystem seeks to avoid adding to uncertainty. In a global market, this orientation provides the world with an invaluable public good. However, focusing on domestic price stability will necessitate flexibility in the long run. This flexibility includes exchange rate flexibility. As indicated by Mundell's famous quartet, if three of the four conditions are fulfilled - free trade, international capital mobility and an independent domestic monetary policy focusing on the maintenance of price stability - it is not possible to maintain fixed exchange rates.

There is widespread agreement that inflation in the medium to long term is a monetary phenomenon. The relationship between money and prices is one of the more strongly stylised facts in economics. There are good reasons to believe that this relationship will remain robust in the face of structural changes and globalisation, as it proved to be in the past. In its monetary policy strategy the Eurosystem therefore gives a prominent role to money. This is signalled by the announcement of a reference value for the growth of a broad monetary aggregate (M3). M3 includes a wide spectrum of conventional bank deposits, as well as close substitutes for these, such as marketable short-term bank liabilities. Consequently, it is less likely to be affected by portfolio shifts.

When devising its strategy, the Eurosystem took into account the fact that the relationship between money and prices might be affected, in the short term, by the structural changes and behavioural and statistical uncertainties linked to the shift of regime associated with the move to Stage Three of Economic and Monetary Union. Therefore, the concept of a reference value does not mean that the Eurosystem will change its policy stance or react in a mechanical way to deviations of M3 growth from the reference value. A careful analysis of the reasons behind monetary developments must always be carried out before drawing policy conclusions. The prominent role for money implies that monetary developments are thoroughly assessed for the information which they provide with regard to the outlook for price developments. Monetary policy will react in such a way as to address the threats to price stability revealed by this analysis.

In parallel with the analysis of monetary developments, a broadly based assessment of a wide range of economic indicators, including foreign and international developments, will help to inform the Governing Council of the specific nature of the macroeconomic environment and the disturbances to the economy on which monetary policy decisions normally depend. A reliance on a single indicator variable or intermediate target would not prompt the appropriate response in all circumstances. This is all the more true in view of the increasing role of external developments resulting from globalisation and financial market spillovers.

The euro exchange rate plays an important role as it can have an impact on consumer prices, both directly via import prices and indirectly via exports and real activity. However, the strategy eschews mechanistic reactions to exchange rate movements.

The emergence of the euro as an international currency with the concomitant reduction in the number of key players in international monetary relations requires an intensified exchange of information on international monetary issues. However, it should be recognised that international monetary policy coordination such as exchange rate targeting or the coordination of the “global policy-mix” could jeopardise the goal of price stability and endanger the credibility of monetary policy. It could also risk decreasing accountability and reducing transparency. This would clearly be very undesirable.

It seems plausible that in the future further countries will consider anchoring, or decide to anchor, their currency either formally or informally to the euro or to a basket of currencies in which the euro would be a major component. Given the prospects of EU enlargement, visible changes are likely to take place in this area in the near future. The sustainability of pegs to the euro will require that these countries have a sound banking system, follow credible and sound monetary and fiscal policies and enhance, through structural reforms, the flexibility of their product and labour markets. Normally, the closer the exchange rate link, the more important it is that these preconditions should be fulfilled. This is particularly the case for currency boards.

We are convinced that maintaining price stability in the euro area in a way which is credible, irrespective of the role that the euro plays in third countries, is the best contribution which the monetary policy of the Eurosystem can make to favourable developments in the global economy.

Conclusion

Let me conclude by saying that globalisation makes the assessment of the economic environment a more intricate task and the transmission mechanism of monetary policy more uncertain. There will be an increased risk of exposure to the spillover effects of economic and financial disturbances, which will necessitate closer analysis of economic developments from a worldwide perspective. However, we are convinced that we have a monetary policy strategy which is designed in such a way that it can be adapted to varying situations and the new challenges arising from globalisation.