Willem F Duisenberg: From the EMI to the ECB

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the Banque de France's Bicentennial Symposium, Paris, on 30 May 2000.

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Ladies and gentlemen, it is a great pleasure to address such a distinguished audience on the occasion of the Banque de France's bicentenary. Surviving for two hundred years in a sometimes turbulent economic and political environment constitutes a notable achievement. I am pleased to be able to congratulate my French colleagues and the Bank itself on this significant accomplishment and look forward to their continued success in the future as part of the Eurosystem - our name for the European Central Bank (ECB) and the eleven national central banks that introduced the euro in January 1999.

The long history of the Banque de France stands in stark contrast with the youth of the institution I represent today. Tomorrow the ECB will complete its first two years of existence. During this time, the introduction of the euro and the subsequent conduct and implementation of the single monetary policy have, in my view, been a remarkable success. Most importantly, the basis for lasting and credible price stability throughout the euro area has been solidified. Price stability has, in turn, helped to create an environment where economic activity and employment can flourish. Economic prospects in the euro area are better now than at any time for more than two decades. With continued wage moderation, fiscal consolidation and the implementation of long overdue structural reforms to labour and product markets, an extended period of sustainable economic growth is possible - provided that the single monetary policy remains resolutely committed to the maintenance of price stability, taking the necessary prompt action to address inflationary pressures as they emerge. The ECB is strongly committed to this task.

The successful introduction of the euro did not occur by accident. Rather it was the result of a long and painstaking preparatory process. This process started in Basel, under the aegis of the Committee of Central Bank Governors. The Committee of Governors was central to the preparation of the Statute of the ESCB and the Maastricht Treaty and, after the signing of the Treaty, undertook the initial groundwork for the move to Monetary Union. After its creation in 1994, the European Monetary Institute, as the institutional precursor to the ECB foreseen in the Treaty, took over the preparatory work. These preparations drew on the accumulated experience of central banks throughout the world, but - of course - especially those in the euro area. In this sense, the long history of the Banque de France that we are celebrating today - as well as the experience of other central banks - has directly contributed to the success of the ECB during its short initial existence.

In my remarks this morning, I will discuss some of the lessons drawn by the ECB from the rich history of central banking. My comments will focus on three aspects of monetary policymaking: the institutional design of the central bank; the monetary policy strategy; and the operational framework used to implement policy decisions.

The objective of monetary policy - price stability

Monetary policy is not omnipotent. Unfortunately, in the past, this was not always recognised in the design of central bank mandates. Central banks were often charged with meeting several, potentially conflicting, objectives, some of which were simply unattainable using monetary policy alone. Unsurprisingly, the resulting inadequately designed institutional frameworks led to poor overall economic outcomes.

Today, with the regrettable experience of high and rising inflation in the 1970s in mind, the capabilities and limitations of monetary policy are better - although still not universally - understood. A broad consensus now exists that the maintenance of price stability is the appropriate objective of monetary policy. This consensus is rooted in the belief that monetary policy makes its best contribution to overall economic welfare by maintaining price stability - and thereby allowing the relative price mechanism to work more efficiently. It goes without saying that this is a consensus with which I fully concur.

The institutional framework for the single monetary policy described in the Maastricht Treaty reflects this economic consensus. Of course, the Treaty was written with the experience of European and other central banks in mind. First and foremost, the Treaty clarifies the objective of the ECB. It establishes a clear hierarchy of objectives for the single monetary policy, with price stability unambiguously assigned overriding importance.

How should this mandate be achieved? The experience of the 1970s and 1980s demonstrated the advantages of central bank independence in the pursuit of price stability. A monetary policy subject to short-term political concerns and influences could not adopt the medium-term orientation required to maintain stable prices credibly. Academic studies of the time consistency problem in monetary policy offered an insight into this issue, while empirical evaluations showing a correlation between central bank independence and greater price stability provided compelling supporting evidence. By the early 1990s, the benefits of central bank independence had become conventional wisdom. An increasing number of central banks achieved greater institutional independence. This worldwide trend was reflected in the Maastricht Treaty, which made the ECB one of the most independent central banks in the world.

Assigning responsibility for an important public policy to an independent institution needs to be accompanied by a transparent and accountable policy framework. In a democratic society, a high degree of transparency and accountability in monetary policymaking should bolster both the legitimacy of the central bank and public support for its price stability mandate. At the same time, transparency and accountability impose an external discipline on policymakers which can add to the credibility, and thereby the effectiveness, of monetary policy. The ECB has set high standards in both regards by establishing channels for communication and accountability suited to the specific, and distinctive, institutional and cultural setting in Europe.

I will return to the important issue of transparency in a moment, when I discuss the ECB’s monetary policy strategy. With regard to accountability, let me simply highlight that, drawing on the successful experience of several central banks, in October 1998 the Governing Council of the ECB decided to publish a quantitative definition of price stability. This definition of price stability as an annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% provides a clear yardstick against which the public, its elected representatives and agents in the media can hold the ECB accountable.

The ECB’s monetary policy strategy

Within this institutional framework, how should price stability be maintained? This question is addressed by the ECB’s monetary policy strategy. It is obvious that the development of the ECB’s strategic framework drew heavily on the experience of euro area NCBs prior to Monetary Union. This is one area where the experience of national central banks was extremely influential and important.

Prior to the introduction of the euro, several central banks, including the Banque de France, assigned a prominent role to money within their monetary policy strategy. Some announced intermediate monetary targets, while others adopted monitoring or reference ranges for monetary growth. At the same time, other euro area central banks emphasised the role of inflation forecasts as the key monetary policy indicator. Of these, several proceeded to announce direct inflation targets, as became fashionable in the 1990s. Furthermore, many NCBs in what is now the euro area were pursuing exchange rate targets within the context of the European Monetary System. In several cases, central banks adopted various combinations of the above approaches.

This rich and varied experience provided the context in which the ECB’s strategy was designed. I should like to make two observations.

First, the range of approaches employed by NCBs in what is now the euro area was considerable. Nevertheless, once the commitment to price stability was affirmed, each of these approaches achieved a large measure of success. The convergence of inflation rates to low and stable levels across the euro area in the 1990s was a significant - and, in many quarters, unexpected - achievement. In my view, this experience offers a powerful illustration that there are several ways to achieve and maintain price stability. The strategy adopted by a central bank should reflect the circumstances that it faces, including the initial conditions and consequent need for transition. Those who claim that there is only one acceptable or efficient way to operate monetary policy fly in the face of history and experience.

Second, on the basis of our investigations of these various approaches conducted at the EMI, we concluded that the differences among various central bank strategies - differences which are often highlighted in the academic and journalistic debate - are much less important than the similarities. Certain key elements - for example, affirming a commitment to the objective of price stability; defining this objective clearly; evaluating a broad range of indicators, including monetary aggregates, real and financial variables and macroeconomic forecasts - were, in fact, common to all successful strategies.

Taking note of these two observations, the Governing Council of the ECB adopted a strategy which aimed to maintain some continuity with the strategies pursued by NCBs in the euro area prior to Monetary Union while, at the same time, ensuring that the new and distinct challenges facing monetary policy in a wholly new currency area were appropriately addressed.

We recognised at the outset that the key feature of a successful strategic framework for monetary policy can be described in very simple terms. Monetary policy must always be determined in the manner which best serves the maintenance of price stability over the medium term.

In taking monetary policy decisions with the goal of price stability in mind, the Governing Council relies on the information about the economic situation and the threats to price stability that is revealed by a thorough analysis of a very broad range of economic indicators. As NCB experience has demonstrated, the relevant set of indicators is potentially very wide. In consequence, the ECB adopts a "full information" approach, ensuring all the relevant information is encompassed in the analysis. To impose some structure on this body of information, these indicators are organised in the context of the strategy's two pillars. Imposing such structure facilitates the pursuit of the strategy's interrelated roles, namely the promotion of an efficient internal decision-making process and the creation of a clear external framework for the presentation and explanation of policy decisions to the public.

The first pillar of the strategy, which assigns a prominent role to money, reflects the fundamentally monetary origins of inflation over the medium to longer term. The prominent role of money is signalled by the announcement of a reference value of 4½% for the annual growth rate of the broad monetary aggregate M3. It is crucial to recognise that we do not interpret the first pillar as either an intermediate monetary target or solely in terms of the reference value. The first pillar embodies a thorough analysis of the components and counterparts of M3, which always takes place in the context of other indicators. The aim of the analysis is to extract information contained in the monetary and credit data that is required by monetary policymakers to take decisions. In consequence, the analysis naturally focuses on the information content of money regarding the outlook for price developments considering both inflationary and deflationary risks. The first pillar therefore represents an approach within which monetary developments are the main determinants of the evolution of the price level over the medium term.

We are aware that the conditions needed to give a prominent role to money are not as favourable elsewhere in the world as they are in the euro area. However, in the euro area, all the available evidence so far points to the existence of a stable relationship between M3 and price developments over the medium term. M3 and other monetary and credit aggregates also demonstrate leading indicator properties for future price developments. In the end, it is this evidence which makes us confident that monetary and credit aggregates are an important indicator for assessing risks to price stability.

The second pillar of the strategy is associated with a complementary, but more eclectic, approach, which implies that a wide range of indicators is of relevance for monetary policy. While inflation is a monetary phenomenon over the medium term, at shorter horizons it will be influenced by many other variables. Changes in international commodity prices, such as the price of oil, will influence developments in consumer price inflation. Demand and cost pressures can also influence price developments in the shorter term. Moreover, policymakers will generally need to tailor their actions to the prevailing economic circumstances, since the impact of monetary policy on the future evolution of the price level at any specific time will depend on a host of factors which are not captured by monetary data. Analysis under the second pillar is intended to reveal this information, giving policymakers greater insight into shorter-run price dynamics and their implications for monetary policy.

Monetary policymaking in the euro area has to reflect the complexities and uncertainties which surround the transmission mechanism of monetary policy in a wholly new economic entity. These uncertainties imply that no single approach is likely to be entirely reliable. The inherent uncertainty faced by the central bank cannot simply be wished away. Reliance on a single indicator or forecast, or a single model of the economy or view of the world, would, in these circumstances, be extremely unwise. The strategy needs to incorporate the full range of relevant indicators and assess them in the context of a variety of different models. In this respect, the two pillars complement one another. They allow for a structured cross-checking of the evidence and analysis underlying policy decisions, encompass all information and allow for various views of the structure of the economy.

The academic literature and other external commentators are slowly coming to recognise the importance of "robustness" in monetary policymaking - something which I believe has been understood by central bankers for some time. A successful monetary policy is not one that performs "optimally" in the context of a specific model or given a particular view of the world. In the light of our limited understanding of how the economy works, no single model is reliable enough. Rather - given the great uncertainty faced by central banks - a successful monetary policy should perform well in a broad range of possible situations and across a variety of models or views of the world, each one of which may capture important aspects of actual economic behaviour or may, ex post, turn out to be close to reality.

Monetary policymaking is therefore complex. The two-pillar strategy chosen by the Eurosystem - where these pillars represent distinct, yet complementary, approaches - captures this complexity in an honest and genuinely transparent manner.

This naturally brings me to transparency - a topic of considerable and ongoing debate in the euro area. In my view, the transparency of the monetary policy process is best understood as the extent to which the external, presentational role of the strategy is consistent with the internal, decision-making procedure. As a party to both the decision-making and the presentation of the single monetary policy, I can assure you that the correspondence between the internal and external aspects of the Eurosystem's strategy is extremely close. Discussions in the Governing Council take into account, on the one hand, an analysis of monetary developments and their implications for monetary policy and, on the other, an assessment of other financial and economic indicators, including macroeconomic projections based on conventional forecasting models and expert judgement. Comparisons are drawn and links are made between these two forms of analysis. Decisions are based on the information revealed through this exercise. The two-pillar framework that is used to explain policy decisions to the public therefore mimics rather precisely the internal decision procedure. Honesty is thus at the heart of the Eurosystem's approach to communication.

An inevitable consequence of our honesty in the face of a complex, uncertain and changing environment is that the ECB's strategy cannot be simple, in the sense that it cannot be described using a single indicator or forecast. We acknowledge that this can make our strategy more difficult to understand, especially at the outset. Sometimes the strategy is accused of lacking clarity on the grounds that the two-pillar approach is rather complicated and therefore unclear. However, alternative strategies would only achieve clarity in a superficial sense. Rather than being simple, they may actually be simplistic - and therefore misleading.

Drawing together these arguments, let me emphasise that a monetary policy strategy should not be seen as a machine that mechanically delivers policy decisions. There must be room for a diversity of views, for deliberation and for judgement in the Governing Council's discussion. Monetary policymaking cannot be reduced to a reaction to a single figure, be it monetary growth or an inflation projection taken from a model or a group of experts. Nor can monetary policy be formulated on the basis of a single chart, however colourful. The ECB's strategy provides scope for extensive debate and the exercise of informed judgement, both of which are essential to policymaking. Taking an eclectic, more diversified approach to inform policy judgements - as is implicit in the two-pillar approach - is likely to lead to a better understanding of the economy, to produce better policy advice, allow better policy discussions and therefore reduce the risk of policy errors. This robust approach to monetary policymaking is at the heart of the ECB's strategy.

The Eurosystem's operational framework

Before concluding, I should also like to make a few additional remarks on the operational framework used to implement monetary policy decisions in the euro area. For good reasons, the design of the operational framework was heavily influenced by the experience of NCBs prior to Monetary Union. Maintaining continuity with the pre-existing procedures and instruments was an important consideration. At the same time, the introduction of the single monetary policy offered an opportunity to design the operational framework afresh, ensuring that best practice was adopted throughout the euro area.

The resulting framework provides for a broad set of instruments and procedures to implement monetary policy. Thus far, this framework has worked very effectively in clearly signalling the stance of monetary policy and containing the volatility of short-term market interest rates. At the heart of the framework is the so-called "corridor" for the overnight market interest rate, which is defined by the interest rates on the deposit and marginal lending facilities. With the help of the minimum reserve system, the behaviour of the market rate within this corridor is smoothed, without recourse to fine-tuning interventions by the authorities that might be prejudicial to the market orientation of the system. With these features, the ECB has a very simple but probably also one of the most modern operational frameworks in the world.

Concluding remarks

Earlier this month I participated in a celebration of the 150th anniversary of the Nationale Bank van België/Banque Nationale de Belgique. Today we celebrate the Banque de France's bicentenary. It would have been extremely foolish if the Eurosystem had not exploited the accumulated wisdom and experience gained from the long and distinguished history of these institutions and those of the other NCBs. As I have argued today, both the Eurosystem's strategy and its operational framework have exploited this wisdom to the full, while recognising the new and different challenges faced by the single monetary policy in the euro area.

Let me therefore finish by again congratulating the Bank on its bicentenary, by expressing my gratitude to all those who have dedicated their time and effort to the achievement of Monetary Union and, finally, by wishing the Bank another 200 successful years - and more - as an important and vital component of the Eurosystem.