Christian Noyer: The euro in 2000 - principal features of the European Central Bank's monetary policy

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the Recoletos Forum, held in Madrid, on 29 June 2000.

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Ladies and gentlemen,

It is a great pleasure for me to speak to you here at the Recoletos Forum in Madrid.

In order to provide you with the perspective of the European Central Bank (ECB) on the performance of the euro as the single currency of the euro area, it will be helpful if I begin with a review of the objective of the single monetary policy and its underlying strategy, as well as the operational framework of the Eurosystem (ie the ECB and the 11 national central banks of the countries which have introduced the euro). After I have made some comments both on monetary and economic developments which have taken place in the euro area and on the risks to price stability as they have appeared in the first months of 2000, I shall outline the responsibilities of the individual policy areas in achieving and sustaining high growth in an environment of price stability. I shall then discuss the euro's role in the financial markets. Finally, I shall conclude with a view on the general prospects for the euro area and its single currency.

The monetary policy objective, strategy and operational framework

As is well known, the main objective of the Eurosystem is the maintenance of price stability. From today's perspective, the maintenance of price stability seems to be the natural objective of central banks. Looking back at the postwar decades, however, reveals that this objective has not always been assigned to central banks, even less achieved. At the same time, it shows the negative consequences of a monetary policy which is not strictly geared towards price stability. In particular, the experience of the 1970s and early 1980s clearly confirmed the following three principles: first, that inflation is a clear obstacle to sustained economic growth; second, that central banks cannot afford to pursue several different, potentially contradicting objectives; and, finally, that their independence is essential in order to secure this medium-term objective for the common good.

For this reason, the Eurosystem has been assigned the clear objective of maintaining price stability. In order to make this objective more precise and explicit, the Governing Council of the ECB has decided that price stability should be defined as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". According to this definition, price stability "is to be maintained over the medium term".

In order for the Eurosystem to achieve price stability, there is a need for a clear strategy, for adequate and timely monetary decisions and for an efficient operational framework, in order to ensure that these decisions are effectively transmitted to the financial sector and ultimately to the whole economy.

Let me first say a few words about the Eurosystem's strategy. It is based on two pillars, the first of these being a prominent role for money, and the second a broadly based assessment of the outlook for price developments. Inflation is ultimately a monetary phenomenon; thus, giving money a prominent role in its monetary policy analysis is quite natural for a central bank geared towards price stability. The important role assigned to money is reflected in the announcement of a reference value of 4½% for the annual growth of the broad monetary aggregate M3. Current M3 growth is analysed and interpreted in relation to this reference value. Under normal conditions, substantial or prolonged deviations of monetary growth from the reference value would signal risks to price stability over the medium term. For the euro area, this relationship is empirically well founded. Available econometric evidence suggests the existence of a stable relationship between M3, the euro area price level and a small number of other area-wide macroeconomic variables. Moreover, there is solid evidence with regard to the leading indicator properties of M3 for future price developments. While there can be no doubt as to the relevance of monetary growth for inflation in the medium term, short-term changes in the stock of money may be influenced by factors unrelated to future spending and future inflation. Thus, the Eurosystem does not react mechanically to short-term deviations of monetary growth from the reference value. Instead, monetary developments are analysed very carefully in order to extract their information content with regard to future inflation. If this analysis suggests that monetary developments are a threat to future price stability, monetary policy will respond in a manner appropriate to counter this risk.

In parallel with the monitoring of monetary aggregates, the ECB also pays close attention to various other indicators which may signal inflationary risks or tensions: this is the second pillar of the monetary strategy. Indeed, while inflation is a monetary phenomenon over the long term, it is useful in the short to medium-term to detect those inflationary tensions in the economy - reflected in various real and financial indices - which are not captured by monetary aggregates.

With these two pillars and the various indicators, monetary policymaking in the euro area may appear complex, but this reflects the complexities and uncertainties which surround the transmission mechanism of monetary policy in modern economies, and, even more so, in the new economic environment created by the changeover to the euro. Against this background, the Eurosystem must rely on a whole range of indicators and on a variety of models which help to sharpen and crosscheck the analysis.

The efficiency of monetary policy does not rely only on a careful analysis of the monetary, financial and economic situation, but also on the ability to explain monetary policy decisions to the public in a convincing manner. In the case of the Eurosystem, this is an even more arduous task than usual, as the single monetary policy must cope with a new environment and be explained to a public from different cultural backgrounds on the basis of new indicators and data. Our choice is to base this communication on transparency. This means that our external presentation of monetary policy must fully reflect the internal analysis and discussions which take place within the Governing Council. I can personally assure you that this is the case. Our internal discussions are organised in such a way as to ensure a full and thorough assessment of the two pillars I have just described. Our external communications fully reflect this.

In addition to a well-defined and informed strategy, the monetary policy of the Eurosystem must rely on an efficient operational framework, that is, on a set of instruments and procedures necessary for the implementation of monetary policy. Thus far, this framework has proved successful in clearly signalling the stance of monetary policy, in steering short-term market interest rates and in providing liquidity to the banking system in an efficient manner. At the heart of the framework are the weekly refinancing operations which were conducted at interest rates broadly in the middle of the interest rate corridor, which is set by the rates on the two standing facilities. A minimum reserve system ensures the existence of a liquidity deficit in the banking system, which is necessary for the conduct of these weekly open market operations. The credit institutions need only comply with the minimum reserve requirement on average within the reserve period. This contributes to the stabilisation of money market developments. A key element for the functioning of the operational framework has been the TARGET payment system. This payment system interlinks the 15 national real-time gross settlement systems and the ECB's payment system, by providing a uniform platform for the processing of cross-border payments in real time. It has allowed a single interbank market interest rate across the euro area to prevail.

Overall, the operational framework of the Eurosystem has proved efficient in providing liquidity to the banking system. This does not mean that this framework is rigid. On the contrary, it must adapt to the situation and evolution of the money market in the euro area. In this regard, the Eurosystem switched from a fixed to a variable rate tender for its refinancing operations on 8 June 2000. Let me make clear that this technical decision does not in any way modify the stance of the Eurosystem's monetary policy, nor does it preclude renewed use of fixed rate tenders in the future. The sole aim of this changeover is to address the severe overbidding problem which developed in the context of the fixed rate tender procedure.

Monetary and economic developments in the euro area

Turning from theory to practice, I shall now consider current monetary and economic developments in the euro area.

As you know, the Governing Council of the ECB raised the rate of its main refinancing operation, and that of the deposit facility and the marginal lending facility by 0.5 percentage points to 4.25%, 3.25% and 5.25% respectively on 8 June. This decision was based on the conclusion that both pillars of the monetary policy strategy pointed to upward risks to price stability in the euro area in the medium term. Let me elaborate on this.

With regard to monetary developments, M3 growth has deviated from its reference value since the beginning of 1999. This deviation has increased further since the beginning of 2000. Thus, the three-month average of the annual growth rates of M3, covering the period from February to April 2000, increased from 5.9% in the preceding three-month period, to 6.3%. As a consequence, the deviation of M3 growth from the reference value of 4½% rose to almost 2 percentage points. The assessment of there being ample liquidity in the euro area was further supported by the continuing rapid expansion of lending to the private sector. The annual growth rate of lending to the private sector stood at a very high level throughout 1999 and in the first few months of 2000. Important determinants underlying this development are strong economic activity in the euro area and very favourable industrial and consumer confidence. It must also be noted that real lending rates, although they have been rising since the spring of last year, are still lower in real terms than those observed at the beginning of 1999. Overall, money and credit developments signalled an upward risk to price stability which had to be counteracted.

The new monetary data for May which was released this morning broadly confirmed this assessment. The three-month average of the annual growth rates of M3, covering the period from March to May 2000 remained unchanged at 6.3% and loans to the private sector continued to grow rapidly.

Let me now discuss the outlook for growth and inflation. This is a rather pleasant task, as the prospects for strong growth are very favourable. Indeed, let me reiterate our conviction that they have not been this favourable in many years. If central bankers are famous for anything, it would normally be for guarded rather than for exuberant views. So, for a central banker, this assessment is quite something. I therefore hasten to fill you in on some of the underlying details.

The consensus view emerging from the forecasts currently available is that of strong economic growth of over 3% in the euro area both this year and next. This is clearly more than most forecasters expected at the end of last year, when projections were still very much made in the light of the previous crises witnessed in emerging market economies. Since then, there has been a strong upturn in growth in the second half of last year. Available short-term indicators suggest that growth will also be strong in the first half of this year, in line with current forecasts.

The positive outlook for euro area growth incorporated in current forecasts is supported by favourable conditions for growth from both the domestic and the external side. The growth in domestic demand has proved highly robust in the face of the slowdown which followed the Asian crises. The fact that confidence indicators are currently at or close to record highs is fuelling expectations that domestic demand growth will also be strong this year and next. Continued strong employment growth and increasing capacity utilisation, among other factors, should underpin the expansion of private consumption and investment. On the external side, there are now increasing signs that the upturn in growth in the global economy has been stronger, more rapid and more broadly based than was expected at the end of last year. Reflecting this favourable external environment, the growth in euro area exports should remain strong.

There are, of course, some uncertainties surrounding euro area growth prospects. These come mainly from the external side. They are mostly linked to a possible pronounced slowdown in the US economy and the ensuing negative effects on the growth of the world economy.

In the present context of strong growth, the outlook for inflation should be examined thoroughly. In this regard, the risks to price stability remained persistently, up until our recent decision on interest rates, on the upside. According to the forecasts currently available, consumer price inflation in 2000 and 2001 is generally projected to be slightly below 2%. This is clearly higher than was expected in the respective forecasts at the end of last year and early this year. We should, of course, bear in mind that these forecasts are snapshots of economic prospects as they appear at a particular point in time. They are typically surrounded by a fair degree of uncertainty and they are highly conditional on a number of specific assumptions. Oil prices and exchange rates are prominent examples of such forecast assumptions. The movements in these variables in the past few months show how quickly such assumptions can move out of line with actual developments. Moreover, in the case of the forecasts currently available, some of these explicitly assume that short-term interest rates will rise over the forecast period. I think that it is fair to say that without this assumption projected inflation would most likely have been higher in the forecasts concerned.

Thus, the inflation outlook for the euro area gave a very clear signal to monetary policy: namely that there was no reason for complacency and that monetary policy had to react. The developments in oil prices and the exchange rate have led to a strong rise in import prices. The (lagged) effects of this rise in consumer prices are unlikely to have fully materialised as yet. In the context of the aforementioned prospects for strong economic growth in the euro area, the protracted rise in import price inflation in the past few months clearly gave rise to a greater danger of a spillover to domestic sources of inflation, such as, for instance, firms aiming at raising or restoring profit margins. These risks had to be counteracted.

With our monetary policy we are contributing to the conditions for high, sustained, non-inflationary growth. Since November of last year, the Governing Council of the ECB has decided to raise interest rates by a total of 175 basis points. Admittedly, this is not negligible. Given the strong economic data, the continuously high level of confidence and the continued strong growth of money and credit, the increase in interest rates does not mean that the ECB has put the brakes on growth. Economic expansion in the euro area is now strong enough not to be hurt by a gradual adjustment of the monetary policy stance. The interest rate moves are providing a clear signal to market participants, social partners and policymakers that the ECB is determined to counter inflationary dangers in a timely fashion, and that the prospects for price stability in the euro area remain good. This is also of great importance for the longer-term potential of the euro.

The responsibilities of individual policy areas in ensuring sustained non-inflationary growth

This brings me to a crucial issue: the single currency is the joint responsibility of all policymakers and Member States. Monetary policy is strictly geared towards the maintenance of price stability and thus also makes an important contribution to strong growth in output and employment. However, monetary policy needs the support of other policy areas. This is best achieved by having specific roles, clear mandates and agreed responsibilities for the individual policy areas. Let me go into these in a little more detail.

The best contribution which monetary policy can make to sustainable growth is to achieve price stability. Indeed, inflation entails numerous costs and creates an uncertain economic environment. This is harmful to an optimal allocation of resources and thus hampers economic growth. Some costs of inflation are quite tangible, as is the case with those induced by the periodic revision of prices and indices or the increasing cost and time spent in cash transactions. More generally, increased inflation is accompanied by increased volatility of inflation. Stable high inflation has almost never been observed, and is seemingly a contradiction in terms. This volatility of inflation creates uncertainty which affects economic and social decisions. For instance, wage negotiations and settlements are complicated by the necessity of establishing some form of indexing system with frequent revisions; interest rates incorporate a risk premium, which increases the cost of financing; the volume and the direction of long-term saving and of investment are affected by unnecessary uncertainty with regard to the future level of prices. Finally, as high inflation is never well predicted, price increases will create undue wealth transfers between economic agents or sectors. This will bias the indicators of economic return, and divert time and resources for the purposes of either sheltering or taking profit from inflation.

To summarise, price stability is a prerequisite for the efficient functioning of the system of relative prices. A well-functioning relative price mechanism reflects the demand for, and cost of, goods and services in a market economy and allows an optimal allocation of real and financial resources.

The contribution made by price stability to sustainable growth also has a social aspect. In the long run, economic growth is likely to be affected by a situation in which undue and non-transparent wealth transfers occur, which give rise to social discontent and eventually undermine the stability of society. For instance, inflation creates a well-established fiscal bias, as tax bands may not be sufficiently updated or because interest incomes are taxed, whereas they incorporate a risk premium which does not constitute an effective income in itself, but rather compensates for the depreciation of financial capital. In addition, inflation mostly affects social classes less able to protect themselves against changes in nominal prices, if only because the larger part of their financial assets is held in a current account with no or fixed interest. Moreover, as I mentioned earlier, inflation tends to discourage long-term saving, especially that directed towards pension funds. This prevents people from securing their savings for long-term purposes in a reliable way. In the long run this could affect the people's sense of belonging to society.

As John Stuart Mill once said, money (we might say price stability) is one of those instruments whose importance is only felt when put out of order. Over the last century, the European economies and societies have had sufficient experience of this to value the wisdom of this judgement. Times may, of course, have changed. You may think that this concern is now a bit old-fashioned. I would just say that monitoring and combating inflationary pressures is a permanent task. It is an essential feature of a market economy that it will generate inflationary or, less often, deflationary tensions from time to time. It is not because the river is regulated that the dam is useless!

What about the other policy areas? How can they best contribute to sustaining high non-inflationary growth? Taking stock of the broad policy developments currently observed in the euro area might suggest that there is little to worry about. Recent wage settlements have been relatively moderate, public finances have improved, deregulation and liberalisation are under way in a number of sectors, and there are signs that labour markets are gradually becoming less rigid. However, while it is acknowledged that progress is being made, it is also clear that there is still quite some way to go. Further efforts are required in all these policy areas in order to create the best conditions for the current upswing in economic activity to be turned into a period of sustained strong growth in an environment of price stability.

For fiscal policies the challenge and opportunity is to use the current economic expansion to intensify the necessary further consolidation of public finances. In a number of Member States the budgetary situation is still too far from reaching the targets specified in the Stability and Growth Pact, namely that budgets are to be in surplus or at least close to balance. Moreover, the recent reduction in deficits has been greatly helped by the relatively low levels of interest rates and by improving economic conditions. According to most forecasts, fiscal trends over this year and the next even point to a procyclical stance rather than to prudent anticyclical policies. The overriding goal for fiscal policy should be to shelter governments' budgets from normal cyclical fluctuations, but also from unexpected shortfalls in revenues and interest rate increases. In addition, governments' budgetary policies also need to urgently address longer-term issues in the context of the imminent problem of ageing populations. Many governments are as yet insufficiently prepared for this problem, inasmuch as they are still highly indebted and are not pursuing the structural reform of public transfer systems with sufficient vigour.

The assessment that much has been achieved, but that, at the same time, much remains to be done, also holds true in the case of general economic policies. The structural reform of labour and product markets remains the key to achieving significant reductions in unemployment. There is by now broad consensus on the fact that the larger part of the still very high level of unemployment in the euro area is of a structural nature. Only flexible labour markets will prevent bottlenecks from emerging and triggering upward pressures on prices at a relatively early stage of the current economic upswing.

Looking at the regulatory reform process across the euro area, a good deal of deregulation and liberalisation of previously sheltered sectors have taken place in recent years. There remains significant scope for further action along these lines. In regulated industries, a low level of competition is often accompanied by a high level of public ownership. Privatisation and regulatory reform should thus be seen as mutually reinforcing measures. The favourable impact of such measures in terms of lower price increases has become clear in the case of the telecommunications and energy sectors. This should be encouragement enough to step up efforts in other sectors. Notwithstanding significant demands on labour mobility in the short term, increased competition in previously sheltered sectors will usually result in longer-term employment gains.

Responsible wage policies are of crucial importance for the maintenance of price stability and the creation of new jobs. Wage growth has been relatively moderate in the past year. The outcomes of recent wage bargaining in the individual Member States signal that it will also remain moderate throughout the current year, and possibly next year too. What is required is lasting wage moderation which simultaneously ensures consistency with price stability and allows for net employment gains. In times of high unemployment, this means that real wage increases should not fully exploit productivity increases. By accepting these responsibilities, the social partners would be acting in their own interests. Monetary policy needs to, and will, be conducted in such a way that the partners in the wage bargaining process can be confident that price stability will be maintained.

Overall, the point which I made earlier in respect of monetary policy also holds for other policy areas: there is no reason for complacency. At the same time, with all the appropriate policies in place, the momentum of sustainable non-inflationary growth could eventually be even stronger than is currently anticipated. This would indeed mean a great step for the euro into the year 2000 and beyond.

The euro and the financial markets

The creation of the euro has accelerated the development and integration of the capital markets in Europe, which, in recent years, have also been fostered by financial liberalisation and technological innovation. This also contributes to high growth, as more efficient financial markets help in allocating funds to their best use. In effect, the single currency has removed the exchange risk between the countries of the euro area. It is facilitating the standardisation of debt instruments and their management on a larger scale. This integrative effect of the euro has been most evident in the money market, by virtue of, in particular, the establishment of TARGET, the large-value payment system. This integration has shown itself in, for example, the rapid adoption by the market of reference rates for the euro area, such as the EONIA overnight rate or the EURIBOR for maturities of less than one year. Above all, we have seen a total convergence in short-term interest rates within the euro area.

In bond markets, the integration of markets remains incomplete, owing, for instance, to national differences in respect of taxation, accounting and supervisory regulations and payment and settlement systems. Nevertheless, the integration of bond markets is progressing. We have seen European bond indices become standardised. The differences in rates between sovereign issues within the euro area fell substantially in 1998. Furthermore, 1999 was characterised by a spectacular growth in euro bonds issued by private non-financial firms. These issues increased by almost 300% in 1999, as compared with 1998. The increase was particularly large for issues with a lower rating. For example, issues with a Baa rating increased by 500%, albeit from a very low level. From a global perspective, the growth in the bond market is contributing to the internationalisation of the euro. In 1999, international bond issues denominated in euro amounted to 40% of total worldwide bond issues. This constitutes an amount comparable with bond issues denominated in US dollars.

In the same way, the integration of stock markets is progressing, although they will have to overcome barriers of the same kind as those which I have just mentioned in relation to the bond markets. A notable increase in transactions on the new European indices has been observed. Moreover, the "new markets", with growth figures benefiting greatly from the establishment of the large European market, have expanded considerably. Finally, the announcement of stock exchange alliances and mergers over recent months reflects the logic of stock market integration and will accelerate the process.

As I have said, the broadening of the capital markets and their greater integration are contributing to a more efficient allocation of savings. First, this development is leading to lower transaction costs and is increasing the liquidity of the traded instruments. This, in turn, will contribute, all other things being equal, to reducing the absolute level of interest rates. Second, it is multiplying investment opportunities, increasing the range on offer and fuelling competition between issuers. Meanwhile, the deeper market calls for a restructuring of and rationalisation in the finance industry. This should strengthen the management of savings in Europe. To illustrate this trend, let me recall that the total value of mergers and acquisitions involving banks in the euro area clearly exceeded the already high level recorded in 1998. In 1999 it was also above the level for similar transactions reported in the United States.

Conclusion

As I said in my introduction, price stability is the principal objective of the Eurosystem. It is on the basis of this general objective that we assess real and financial developments. It is also the principal criterion on which monetary policy should be judged. This principle of price stability can be considered a major precondition for sustainable growth in the euro area in the years to come. The current environment is favourable: the business cycle in the euro area is oriented upwards, technological innovation is contributing to more efficient production schemes, the creation of the euro is a powerful factor in restructuring European economies and unemployment is falling as a result of, in part, structural reforms implemented by governments. It is up to economic policymakers in the euro area to pursue liberalisation, flexibility, fiscal consolidation and public efficiency. It is up to consumers and producers to reap all the benefits of this favourable environment.