Willem F Duisenberg: Making monetary policy in a broad monetary union

"Jean Monnet" Lecture by Dr Willem F Duisenberg, President of the European Central Bank, at the European Business School London on 12 October 2000.

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Ladies and Gentlemen,

I am very grateful to the European Business School London for having invited me to deliver the annual Jean Monnet Lecture. This is a great honour because the occasion recalls the man who, perhaps more than anybody else, devoted his life to making the European Union a reality. As President of a very young European institution, the European Central Bank (ECB), I feel very close to his intellectual legacy.

Since Jean Monnet's times, the process of integration among European countries has advanced a great deal, and very much in the direction he advocated. Within this process, the creation of Monetary Union, with an independent central bank at its heart, represents a fundamental step. On 1 January 1999, the European Central Bank assumed responsibility for monetary policy in the euro area - the second largest economic area in the world after the United States. Overnight, the euro became the currency of almost 300 million people. I am deeply convinced that this crucial step has created a sound foundation for attaining a substantially higher level of welfare in our economies.

Although the United Kingdom, our host country today, is not yet part of the single currency area, its economy and the 11 - soon to be 12 - economies that have adopted the euro are inextricably interlinked, also through their membership of the European Union.

While remarkable success has been achieved, one should not forget that many challenges, as well as opportunities, lie ahead. These challenges cannot be met and these opportunities cannot be fully exploited without building and enhancing - with full respect for national and regional traditions - a "European culture". This is all the more true of institutions such as the ECB, which assemble their staff from all 15 EU countries in order to fulfil an important public mandate for a large part of Europe, namely the euro area. Ever since the ECB was established, we have made every effort to develop a spirit of cooperation and dedication towards a common goal among our staff, as well as among the members of the Governing Council who hold the responsibility for final policy decisions.

In this sense, Jean Monnet's words "... to make all men work together, to show them that, beyond their divergences or over and above frontiers, they have a common interest" are a universal summons to action, to which we fully subscribe.

Let me now turn to the subject of my lecture, namely making monetary policy in a broad monetary union.

The institutional context

I shall start my presentation with a few remarks on the institutional context underlying the conduct of monetary policy in the euro area.

It is certainly difficult to overemphasise the crucial role played by the institutional framework in determining economic results. The Treaty establishing the European Community (which I will refer to hereafter as the "Treaty") provides, in my view, a very solid foundation for the successful conduct of monetary policy in the euro area. Let me briefly explain why.

First, the Treaty establishes a clear hierarchy of objectives for the single monetary policy, with price stability unambiguously assigned overriding importance. In the past, central banks were often set several, in many cases conflicting, objectives that could not possibly be met by using monetary policy alone. Quite unsurprisingly, this poorly designed institutional framework often led to a mediocre overall economic outcome, as shown by the regrettable experience of high inflation in the 1970s. Today, there is widespread consensus that the maintenance of price stability is the appropriate goal for monetary policy. It is by focusing on maintaining price stability - and thereby allowing the relative price mechanism to work efficiently and at the same time maintaining low risk premia in real interest rates - that monetary policy can make its best contribution to economic welfare. The Treaty, very appropriately, reflects this broad consensus.

Second, the Treaty has made the ECB one of the most independent central banks in the world. Institutional independence of central banks is a crucial precondition for successfully pursuing a monetary policy oriented towards the maintenance of price stability. By insulating the central bank against short-term political concerns and influences, it confers upon the central bank the credibility to commit itself to taking all necessary decisions that best serve the achievement of its final goal. As a large body of theory as well as historical experience show, credibility is a cornerstone of a successful monetary policy. This has become conventional wisdom nowadays and rightly so. Credibility greatly facilitates the conditions for, and enhances the effectiveness of, monetary policy. Once the public is convinced of the central bank's commitment to preserving price stability, they will act - for example, in wage and price-setting - in a way that facilitates the achievement of this goal. A virtuous cycle is created, which is conducive to creating an environment of stable prices in which economic activity can flourish.

Third, the Treaty clearly recognises that assigning an important public policy to an independent institution has to be accompanied by transparent and accountable policy design and implementation. Transparency and the accountability of the central bank serve the interests of democracy, help to bolster the legitimacy of the central bank and, by imposing discipline on policymakers, add to its credibility. I shall return to these issues in the course of my presentation. For the time being, let me just say that we attach crucial importance to both accountability and transparency in the pursuit of our mandate and that the ECB follows best practice in both regards, in many respects going well beyond the literal requirements of the Treaty.

Finally, let me mention the relevant issue of fiscal policy. In Stage Three of Economic and Monetary Union, budgetary policy ultimately remains the competence of the individual Member States. This unprecedented combination of a single monetary policy coexisting with many, distinct fiscal policies has led some critics to even question the possibility of success of Monetary Union. This is, in my view, a wrong perception. What is crucial in the context of the single currency area is that participant countries come to a common view on basic principles. The Treaty, supplemented by the Stability and Growth Pact, reflects a broad agreement and provides for such basic principles in the field of fiscal policy. In particular, it requires that countries in the EU, and especially those that have adopted the euro, respect a common code of fiscal conduct that is expected to uphold discipline in the management of government finances. By promoting sound government finances and thereby imposing limits on the expansion of public debt, the Treaty fortifies the conditions for price stability and for strong, sustainable economic growth in the euro area. This also adds to the credibility of Monetary Union and of monetary policy within it.

The ECB's monetary policy strategy

The institutional setup provided by the Treaty, therefore, ensures a very solid foundation for building and maintaining a high level of credibility for the ECB and for the successful conduct of monetary policy in the euro area. In the end, however, it will be the central bank's own performance that will determine its credibility.

This naturally leads to the following question: how should price stability be maintained? This question is addressed by the ECB's monetary policy strategy, which was adopted by the Governing Council of the ECB and announced in October 1998. The strategy provides the framework for conducting monetary policy in the euro area.

First and foremost, the ECB's monetary policy strategy provides a quantitative definition of the primary objective of monetary policy in the euro area, namely the maintenance of price stability. Price stability has been defined as an annual increase of below 2% in the Harmonised Index of Consumer Prices (HICP) in the euro area. There are many advantages to adopting a clear, verifiable definition of price stability. First, it serves as a guide for our monetary policy decisions. Moreover, it offers precise guidance to inflation expectations, keeping them low and stable. Last but not least, it provides a clear yardstick against which the public, its elected representatives and agents in the media can verify the performance of the ECB, thus enabling them to hold the ECB accountable for its policy decisions.

But there is also another important point that is worth noting here, which touches on the essence of monetary policymaking in a single currency area. The quantitative definition of our objective makes it clear that our decisions are based only on developments in the euro area as a whole. In a monetary union, monetary policy cannot be directed at contrasting inflationary (or disinflationary) pressures in any individual country per se. As a consequence, each country has to conduct its own appropriate internal policies - whether fiscal or structural - in order to contain excessive internal price inflation. In the past, many problems that were of a structural nature in many European countries were simply temporarily hidden by movements in the exchange rates within the area, and their solution was postponed. This is no longer possible. Monetary Union, with an independent central bank devoted to maintaining price stability at its core, clears the waters, so to speak, and unambiguously reveals the source of problems. This in turn, I am sure, stimulates more responsible action on the part of governments, social partners and other economic actors.

Coming back to our monetary policy strategy, in accordance with a widespread consensus among economists and central banks around the world, we recognise that monetary policy must adopt a medium-term, forward-looking orientation. This follows from the well-known fact that there are lags in the transmission of monetary policy impulses to the price level. Today's monetary policy decisions affect the price level only after a considerable period of time.

A medium-term orientation - ie monetary policy focused on maintaining price stability over the medium term - acknowledges the existence of short-term volatility in prices, resulting from the impact of shocks that cannot be fully anticipated. Moreover, a medium-term perspective is important in order to permit a gradual and measured response to unforeseen economic disturbances. It thereby avoids introducing unnecessary volatility and uncertainty into the short-term interest rate and the real economy.

A forward-looking orientation requires that the central bank regularly evaluate the available economic information in order to assess risks to future price stability. In order to impose some structure on this potentially very large body of information, the ECB's monetary policy strategy foresees two forms of analysis. These two forms of analysis have been called the two pillars of the ECB's monetary policy strategy. Let me briefly explain what they are.

The first pillar of the strategy is a prominent role for money, reflecting the fundamentally monetary origins of inflation. In contrast to other countries where monetary developments in recent decades have been quite erratic, available evidence in the euro area continues to point to a stable relationship between monetary aggregates - in particular M3 - and the price level. Moreover, M3 and other monetary and credit aggregates demonstrate good leading-indicator properties for future price developments, especially at medium-term horizons. On the basis of this evidence, the first pillar is often viewed as a "compass" for monetary policy, which offers guidance to the medium term.

The prominent role for money is signalled by the announcement of a reference value of 4½% for the annual growth of the broad monetary aggregate M3. The announcement of the reference value represents a public commitment on the part of the ECB to thoroughly analyse and explain monetary developments and their role in policy decisions.

However, it is important to emphasise that we do not interpret the reference value as an intermediate target. The ECB does not attempt to control monetary growth at a specific horizon. Rather, the reference value represents an analytical tool, which constitutes a benchmark that can act as a starting point for policy discussion. Moreover, the first pillar encompasses a broader range of analyses of monetary and credit aggregates with the aim of extracting information regarding future price developments. In short, the first pillar represents a view of the world within which monetary developments determine the evolution of the price level over the medium term.

While inflation is ultimately a monetary phenomenon, a monetary policy aiming to maintain price stability over the medium term must clearly evaluate a broader range of variables. In order to take appropriate decisions, the ECB needs to have a deep understanding of the prevailing economic situation and be aware of the nature and magnitude of the shocks that pose a threat to price stability.

The second pillar of the strategy evaluates a broad range of mainly non-monetary indicators. It analyses the influence of a number of factors that can affect the outlook for price stability. Typically, this analysis is centred on the effects of imbalances between supply and demand and/or cost pressures in the goods and labour markets on pricing behaviour. It also takes into account a host of domestic and external factors (including the effects of changes in indirect taxation, fluctuations in the exchange rate and international commodity prices). Moreover, financial market indicators and asset prices - which might provide important insights into the main channels of the transmission mechanism and reveal information about market expectations - are regularly and thoroughly monitored.

Within this analysis, macroeconomic forecasting exercises, which are regularly undertaken in collaboration with national central banks in the euro area, play an important role. They represent a very convenient analytical tool. A forecast enables a large amount of economic information to be summarised and organised and a consistent picture of the future economic situation to be formed, in a systematic manner respecting basic economic relationships and accounting identities. In the Eurosystem, these forecasts are based on the staff's technical expertise and represent one of several inputs into the decision-making process. They do not embody the views or judgement of the Governing Council of the ECB. The Governing Council needs, in any case, to make an overall assessment of the risks to price stability using all available information, including that derived from the analysis under the first pillar, but also taking into account forecasts produced by other institutions, financial market expectations, as well as other important information not incorporated in the forecast.

Many of the elements of the strategy that I have just described are not new. A quantitative definition of the ultimate objective, a medium-term and forward-looking orientation and a full information approach to the analysis of economic data are all elements one can recognise in many of the strategies pursued by the most successful central banks around the world. In this sense, the ECB has drawn much from the strategies of its constituent national central banks, as well as from the experience of other central banks outside the euro area.

At the same time, there are also new, distinctive features. The two-pillar presentation differs in some respects from the strategies pursued by other central banks. Not surprisingly, this element has triggered discussion and also an occasional misunderstanding of the ECB's policy framework.

For example, the two pillars have occasionally been misunderstood as implying distinct, possibly conflicting "targets" for our monetary policy. From my description, however, it should be clear that price stability is the only "target", or more precisely, the primary objective of our policy. The two pillars of the ECB's monetary policy strategy provide a framework for organising the large body of economic information available to policymakers in a manner that helps the Governing Council of the ECB to take appropriate policy decisions in order to maintain price stability. They are not distinct targets in themselves.

In my view, a diversified, multi-pillar framework of analysis offers great advantages. Let me try briefly to explain what they are.

Monetary policy is always conducted in an uncertain environment. This reflects not only the inevitable uncertainty related to the inherent partial predictability of economic phenomena, which becomes manifest in the form of shocks that cannot be predicted in advance. It also reflects the inevitably imperfect measurement, interpretation and understanding of the available information on the economy. Moreover, in the euro area, uncertainty is probably exacerbated by the regime shift associated with the introduction of the euro. This implies a substantial structural and institutional change.

In such a situation, relying on a single indicator or on a single model of analysis entails considerable risk. In an uncertain world, putting all one's eggs into a single basket is never a good idea.

The two pillars of our strategy provide for a diversified approach by embodying and organising the main approaches to assessing the risks to price stability, namely, on the one hand, an approach which assigns a crucial role to money and, on the other, a wide range of analyses of the inflation process (focusing primarily on the effects of the interplay between supply and demand and/or cost pressures). These two main approaches are themselves a reflection of a substantial lack of agreement amongst economists on what paradigm or model best represents the functioning of a monetary economy. As yet, no single, unified and uncontroversial framework has been developed. The two-pillar structure of the strategy helps to ensure that information and analysis from one methodological perspective is always cross-checked against information and analysis from the other perspective. This provides effective insurance against the uncertainties and complexities of the economic environment and helps reduce the risks of policy errors, thereby enhancing the robustness of monetary policy decisions.

Quite naturally, there may be occasions on which the indications derived from the analysis under the two pillars are different or even conflicting. However, this potential tension should not, in my view, be considered a drawback of the strategy. On the contrary, it actually constitutes the essence of a robust approach to monetary policymaking. Attempts to reconcile results yielded by different approaches stimulate deeper analysis and ultimately lead to a better understanding of the economic situation. This is certainly something I can see from my experience at the ECB.

An assessment of the first two years of experience

Ladies and Gentlemen, after nearly two years of experience, I can assert that the introduction of the single currency has been a resounding success in many respects. During its short period of existence, the ECB can claim to have gained the confidence of investors in the sustained maintenance of price stability in the euro area. The euro has firmly established itself as the second currency in world capital markets. Today, we have a unified money market throughout the euro area, while the process of integration of our capital markets is proceeding. The preparations for the introduction of euro-denominated notes and coins - which will make the euro a more tangible reality for the people in the euro area - are progressing satisfactorily.

Since assuming responsibility for the conduct of monetary policy in the euro area, the ECB has faced a number of difficult challenges. After its first decision to lower its policy interest rates in April 1999, the ECB has raised its policy rates seven consecutive times, starting in November 1999 through until the last move one week ago. These decisions were taken to counteract the emergence of risks to price stability in the euro area. The analyses conducted under both pillars of our strategy corroborated our decisions. The analysis under the second pillar indicated that external shocks, namely the strong increase in oil prices and the depreciation of the euro, were increasingly putting pressure on prices. A passing-through to consumer prices was facilitated by the faster pace of economic growth that was progressively materialising in the euro area. At the same time, the analysis of monetary and credit aggregates under the first pillar of the strategy was also signalling the existence of very generous liquidity conditions in the euro area. This also pointed to potential upside risks to price stability.

With respect to these monetary policy decisions, it is clearly too early, given the lags in the impact of monetary policy actions on price developments, to provide a comprehensive assessment. Nevertheless, there are clear indications that these decisions have indeed proved effective.

First, throughout 1999 and early in 2000, inflation remained at low levels. Most of the increase in consumer price inflation in recent months has been caused by a previously unanticipated rise in import prices - due mainly to the substantial oil price increase and the exchange rate depreciation. These developments could not have been offset by monetary policy in the short run. Inflation excluding energy prices is still at a low level in the euro area.

Second, the evolution both of external inflation forecasts and of inflation expectations, as derived from the analysis of long-term interest rates (in particular, index-linked bonds), indicates that financial markets and economists widely expect medium-term price developments in line with our definition of price stability. Obviously, bond yields and many external forecasts incorporate expectations of future policy changes and therefore offer a judgement on prospective monetary policy decisions, as well as on decisions taken in 1999 and 2000. As such, they provide a positive assessment of the credibility of the overall monetary framework.

At the present juncture, it is crucial that the recent increases in import prices do not trigger a wage-price spiral, as has sometimes happened in the past. In the 1970s and 1980s, wage-price spirals emerged as some of the sectors of the economy made uncoordinated attempts to pass through the effects of a negative terms-of-trade shock to other sectors. However, since this kind of shock, such as a rise in oil prices, reduces overall domestic disposable income, any such attempt is doomed to fail in the aggregate and only worsens the situation. I believe that the situation is different in many respects today, not least because the ECB, with its clear commitment to the goal of price stability, provides a coordinating mechanism for economic agents' actions by assuring everybody that inflation will remain under control. Nevertheless, the current situation does not make us complacent.

Moreover, to fully exploit the potential of the economy, it is crucial that structural reforms in the labour and product markets in the euro area economies, which are fortunately on the agenda in many countries, proceed at a faster speed. These will both increase the resilience of the economy to adverse shocks and ensure that a higher pace of economic growth in an environment of price stability can be attained. We will continue to remind all economic actors, for the areas under their responsibility, of this necessity.

While the introduction of the euro has been a success and the performance of the ECB in taking the appropriate monetary policy decisions has not been seriously questioned, I find it somewhat disappointing to note how much of the media and public attention concentrates on developments in the foreign exchange market. In my view, it is mistaken to evaluate the experience so far by primarily looking at the developments in the external value of the euro. This tends to eclipse the overall bright picture so far. When was inflation lower in the past, even with the recent tripling of oil prices? When was economic growth in the euro area as high as it is at the moment? Did we not make significant progress in fiscal consolidation over the past decade? Is not unemployment finally falling? Are we not seeing the integration of financial markets in Europe? Europe is doing better than even Europeans themselves appear to perceive. Above all, Monetary Union is about creating the conditions for long-lasting stability and prosperity in our countries and cannot be reduced to a sort of race among major currencies. Historical evidence shows that, over longer horizons, the fundamentals of the economy - such as domestic price stability, the competitiveness of its products, the growth performance - ultimately determine the external value of a currency. Based on this evidence, as I have already said on other occasions, I am very confident that a strong potential for the euro exists.

Having said that, let me add that we view the possible negative impact of the excessive depreciation of the currency on the prospects for price stability in the euro area with concern. Indeed, the recent intervention in the foreign exchange markets has shown that we take this concern very seriously and that we are ready to back up our words with deeds. Furthermore, since a common concern has arisen about the potential implications of a low level of the euro for the world economy, the intervention has shown the determination of the world's major central banks to act jointly, when needed.

External presentation of monetary policy decisions

Overall, it can be said that the monetary policy decisions of the ECB have served the primary objective of maintaining price stability in the euro area well. The strategy has been effective with respect to its internal role of guiding the ECB's policy choices during a period of considerable uncertainty.

At the same time, we recognise that a high degree of common understanding between the central bank and the public at large is in our best interests because, by reducing uncertainty and bolstering credibility, it facilitates the conduct of monetary policy.

This naturally brings me to the external, presentational role of the strategy and to the issue of transparency in the presentation of policy decisions - an issue that has also received great attention in recent years, and rightly so.

Clearly, adopting an approach to monetary policymaking, which is relatively more complex than alternative, simpler, textbook approaches and which presents some new - and therefore unfamiliar - elements, may come at some cost in terms of simplicity of communication with the public. However, in my opinion, transparency in monetary policymaking should be understood as the extent to which the external presentation of the decisions corresponds to the internal decision-making process. As a party to both the internal decision-making process and the external presentation of our decisions, I can assure you that there is a very close correspondence between the two. In this sense, the ECB has taken the view that honesty should be placed at a premium in the presentation of monetary policy decisions to the public. Discussions within the Governing Council centre around the analyses produced under the two pillars of the strategy. Comparisons are drawn between the indications derived from the two forms of analysis and an assessment of the risks to price stability is formed, which provides the basis for our decisions. Information provided to the public, such as that contained in my Introductory Statement to the press every month or in the ECB's Monthly Bulletin, closely reflects the discussions in the Governing Council and the organisation of the decision-making process, as embodied in our strategy.

Adopting simpler communication strategies, which do not correspond to the way we organise our discussions and arrive at decisions, would not serve the interests of transparency. Conversely, adopting a simpler strategy with the sole aim of simplifying the external presentation would not serve the purpose of taking appropriate monetary policy decisions.

The importance that the public and the media have attached to the role of exchange rate developments in monetary policy decision-making is disproportionate. On some occasions, our monetary policy decisions have even been interpreted as a reaction to concerns about the exchange rate per se. A monetary policy reaction by the ECB to the exchange rate always reflects a concern about the implications of the exchange rate for prospective risks to price stability.

As you will be aware, the ECB is considering the publication of its macroeconomic forecasts. This publication should provide an additional forward-looking element for the communication of economic analysis. At the same time, the publication of forecasts will pose a number of additional challenges. There is, for example, the danger that the public will concentrate on the forecast figures, rather than on the analysis, and expect a mechanical reaction of monetary policy to the forecast. However, as I explained when describing our strategic framework, macroeconomic forecasts are only one - albeit important - input into the policy process. They are always evaluated in the context of, and cross-checked against, other analyses, including, most importantly, the analysis conducted under the first pillar of our strategy. Moreover, forecasts do not embody the Governing Council's views. Indeed, because the exercise of policy judgement remains the preserve of the Governing Council, one should not expect developments in the published macroeconomic forecast to mechanistically feed through into policy decisions. The publication of forecasts by the ECB will have to reflect the important, but limited role forecasts play in the monetary policy process.

Monetary policy cannot - and should not - be reduced to some simple, time-invariant policy rule, which links monetary policy decisions to a small number of indicators or a conditional forecast in a mechanical fashion. Such monetary policy cannot be pursued in a world, which is uncertain, complex and constantly evolving. The ECB has taken the view that the uncertainty and complexities in the structure of the economy should be openly and honestly reflected in its monetary policy strategy and, therefore, in the presentation of policy decisions to the public. This is not only transparent, but will also promote a more genuine understanding of monetary policy over time.

In conclusion, there is certainly scope to increase the degree of common understanding between the ECB and the public at large. Clearly, a process of learning and familiarisation with the new regime is required on both sides and there are indeed already indications that the situation is improving. We are working hard to play our part in speeding up this learning process.

Conclusion

Ladies and Gentlemen, let me now conclude by thanking the European Business School London once again for having given me the opportunity to share these thoughts with you today.

Making monetary policy in a broad monetary union is a complex task. With my presentation, I hope I have convinced you that the ECB has the credibility, the appropriate strategy, the technical expertise and the determination to successfully perform this task and fulfil its mandate. For my part, I have little doubt that this is indeed the case.