Christian Noyer: Current issues in monetary policy

Speech delivered by Mr Christian Noyer, Vice-President of the European Central Bank, on the occasion of a conference organised by l'Université Robert Schuman, Institut des Hautes Etudes Européennes (IHEE) Strasbourg, 6 February 2001.

* * *

Ladies and gentlemen,

(Introduction)

It is both a pleasure and an honour for me to speak here at the conference of "L'Observatoire des politiques économiques en Europe" in Strasbourg and to have the opportunity to present some of the "current issues" surrounding the Eurosystem and the ECB's monetary policy before such a distinguished audience. For a central bank, it is essential to attain public understanding and acceptance, so the ECB is endeavouring to explain its policy to a broader public. We believe that communication and transparency are key elements of modern central banking.

The ECB's monetary policy strategy has been a much-debated issue. Therefore, I should like to begin with this topic. In designing the ECB's monetary policy strategy, the ability to deal with structural changes and with the issue of uncertainty has been of the utmost importance. I shall elaborate on these issues later. Finally, I shall turn to our assessment of the current economic and monetary situation in the euro area.

The ECB's two-pillar strategy

The ECB has chosen its own strategy to best suit its particular circumstances. The strategy is well equipped to deal with the uncertainties surrounding monetary policy in general and the introduction of the euro in particular. It provides a clearly defined framework for guiding monetary policy decisions and for explaining these decisions to the public.

Let me briefly recall the principal features of our strategy.

First of all, the ECB has given itself a *forward-looking, medium term-oriented* strategy aimed at fulfilling its primary objective: *price stability*. The first element of the strategy is the quantification of what the Governing Council understands by price stability. This is defined as an annual increase of below 2% in the Harmonised Index of Consumer Prices (HICP) for the euro area. This definition serves to anchor inflation expectations and provides a framework against which the Eurosystem can be held accountable. It clearly emphasises the euro area-wide focus of monetary policy. Short-term fluctuations in the inflation rate are not under the control of central banks. Therefore, it was also announced that price stability is to be maintained over the medium term, imparting a medium-term orientation to the strategy as a whole.

In order to fulfil its primary objective, the ECB's monetary strategy relies on two pillars. The *first pillar* assigns a prominent role to money. A central bank has a natural interest, but also a comparative advantage in analysing monetary developments, because money is - if I may say so - the central bank's "output". There is broad empirical evidence of a long-term stable relationship between money and prices and good leading indicator properties of money in the euro area. The prominent role of money is signalled by the announcement of a reference value for the annual rate of growth of the broad monetary aggregate M3. This reference value represents a visible public commitment to analysing and explaining monetary developments and their implications for price stability in detail. In December 2000, the Governing Council of the ECB reconfirmed the reference value of 4 1/2% annual growth. This rate should be consistent with price stability in the medium term. While the reference value plays an important role in monetary analysis, the assessment of the first pillar goes beyond the evaluation of the deviation of M3 growth from the reference value. It encompasses a variety of approaches which assign a central role to money because of the ultimately monetary nature of inflation, as well as a detailed analysis of the components and counterparts of M3. Thus, an in-depth analysis of the overall liquidity conditions in the euro area is provided.

Despite broad consensus on the fact that inflation is ultimately a monetary phenomenon, the assessment of monetary developments alone does not give an accurate picture of the state of the economy and of the potential risks to price stability. Therefore, for a robust strategy, it is useful to analyse additional indicators relevant for future price stability and to combine them under a second pillar.

The *second pillar* of the ECB's strategy ensures that the interplay between supply and demand in the real economy is sufficiently taken into consideration when evaluating the risks to price stability. It comprises a variety of predominantly non-monetary factors, which are relevant for future price developments. Some of the factors of the second pillar can be especially relevant in the short term, for example the development of oil prices. For monetary policy decisions, it is important to know whether, for example, shocks originate from the supply side or from the demand side of the economy, whether they exert a temporary or permanent influence on prices, or whether they result from a domestic or an external source. As we have experienced in the past few months, an oil price shock, which is an external shock from the supply side, can exert a significant direct influence on consumer prices. In such a situation, the central bank has to assess whether this direct effect will remain temporary or whether it will translate into a more permanent impact on prices. This depends to a large extent on the ability of central banks to keep inflation expectations low. Other indicators of the second pillar, for example the development of labour costs, have a more medium-term content.

Under the second pillar of the strategy, the production of *macroeconomic projections* for real GDP growth and inflation enables some of the factors considered to be structured and summarised. The staff of the ECB and the national central banks have already been providing twice-yearly projections to the Governing Council since the start of Monetary Union. Starting with the December 2000 issue of the ECB Monthly Bulletin, these projections are now regularly made available to the public alongside other indicators and other forms of analysis underlying the ECB's monetary policy decisions. Let me emphasise that the publication of projections reflects the ECB's commitment to openness and transparency in sharing the information and analyses underlying its monetary policy decisions. Furthermore, it does not in any way change the ECB's monetary policy strategy.

The projections are only *one* element of the second pillar considered by the Governing Council. Economic projections can only provide a partial summary of the state of the economy. They cannot possibly contain all the information needed to take appropriate policy decisions. In particular, the results do not in themselves reveal the nature of a shock hitting the economy. The appropriate monetary policy to maintain price stability should always depend on the specific circumstances and the nature and magnitude of a threat. For example, the appropriate response to a one-off increase in oil prices may differ from that given to a wage-price spiral, even if both have the same impact on inflation projections. Therefore, projections must always be supplemented by economic assessments and a detailed analysis of individual indicators.

The ECB's strategy has sometimes been criticised for being rather complex. However, we are convinced that a simple approach would not have been appropriate. Neither a purely monetary approach nor a purely non-monetary approach to the analysis of risks to price stability is able to deliver the best possible results for monetary policy. In the beginning, we were sometimes criticised for "not having decided" between a strategy clearly based on a purely monetary objective and one based on pure inflation targeting. However, I strongly believe that we have made the right decision, as we have only *one* primary objective: price stability. We have also decided in favour of a *robust strategy* in order to achieve our objective. This enables us to use a variety of approaches, involving different analytical frameworks and indicators, which are relevant for our primary objective of price stability in our decision-making process, and to *cross-check* the results. This approach provides the best possible basis for monetary policy decisions.

So far, both pillars have given broadly similar indications with regard to the primary objective of price stability. However, this does not necessarily have to be the case. Let us suppose that both pillars were to point in different directions. Would it really be better if only one of these signals were available? This would undoubtedly make the decision process easier. But, seriously, faced with uncertainty - and that is an essential characteristic of the world we live in - I do believe that it is advantageous to take more than one approach into consideration and not to rely on a single analytical framework. That is basically the rationale for our two-pillar strategy. Furthermore, over the first two years of Monetary Union, there has come to be greater understanding that this is indeed a sensible approach.

Monetary policy in an environment of structural change

Central banking entails, by definition, acting under uncertainty. While this statement holds true in general, it is particularly the case for the ECB. The introduction of the euro had the potential to trigger structural changes in financial, goods and labour markets, which are in part already visible today and may evolve further in the near future.

With regard to financial markets, the integration of national money markets into one area-wide money market has been almost without friction since the very start of Stage Three, which has allowed for an efficient implementation of monetary policy decisions. In the other segments of the financial markets, considerable progress has been made, although the integration process is far from complete. The removal of barriers to exchange rate risk between the countries of the euro area helped to facilitate the standardisation of debt instruments and widen the range of investment opportunities. Portfolio allocation strategies within the euro area are now mainly oriented towards a sectoral selection and, to a lesser extent, a national selection of assets. That is an impressive indication of the ongoing integration of financial markets in the euro area. This trend, in turn, enhances the liquidity of markets and affects the financing decisions taken by companies. Direct financing via capital markets is growing in importance, even though banks are still the most important source of financing in the euro area. Such changes in the financial landscape make the allocation of funds more efficient and are hence most welcome. At the same time, however, they alter the transmission mechanism of monetary policy, and insofar as this alteration is difficult to measure, add uncertainty to monetary policy decisions.

Apart from the *financial* environment, the *real economy* in the euro area is also currently subject to significant change. Monetary Union has enhanced competition between economic agents in the participating countries. Price transparency between the countries has increased. Both consumers and companies are becoming increasingly more aware of price differences and are reacting accordingly. Greater price differences will be harder to justify and maintain, even though differences in the tax systems and in product specifications will continue to exert an influence on price setting.

Fiscal policy may be affected, both by increased competition between countries and by the general need to foster employment and growth in order to comply with the challenges of ageing populations. These realities have triggered tax cuts and the start of more fundamental benefit reforms. However, these efforts must be accompanied by a structural reduction in expenditure in order to support price stability, make further progress in fiscal consolidation and boost economic growth.

Overall, the increase in competition, less rigidity and a more flexible structure of the economy should lead to an increase in the sustainable rate of economic growth. However, it is difficult to evaluate the extent of these structural changes and to gauge how quickly their impact will be felt on medium-term growth, particularly at an early stage.

In addition to the specific factors resulting from the introduction of the euro, the rapid change in information and communication technology is likely to add further potential for structural changes in the economy. The possible emergence of a "New Economy" may raise the economy's productive capacity temporarily or on a more permanent basis. Much faster data transfer and the increased transparency of information in a knowledge-based society could enhance efficiency. Even if some of the euphoria surrounding the start of a new economic era has dissipated, as could be seen in stock market developments over the last few months, there remains a remarkable potential for economic change in the future. To date, however, clear evidence of positive effects on the supply side, which may lead to a temporary or even permanent higher potential output growth, is still lacking for the euro area. In addition, it should be borne in mind that the expectation of higher growth and positive wealth effects may also lead to inflationary pressures from the demand side of the economy. Therefore, the implications of the "New Economy" for monetary policy are far from clear.

Monetary policy-makers, whose aim is to maintain price stability, need to exercise particular caution in such an environment of change. I am confident that the ECB is well equipped to cope with this challenge, not least due to the "full information approach" chosen in the form of the two-pillar-strategy.

Of course, not only central bankers face uncertainty, but also private agents. Given this situation, the central bank itself must be an even greater *source of stability*. It must not only avoid any actions which may bring uncertainty to the economy, but must try to stabilise the expectations of private agents. When private agents are uncertain about the objective and the commitment of the central bank to this objective, they tend to shorten their planning horizons. They therefore become less predictable, which ultimately leads to a less foreseeable economic environment.

Thus, it is crucial for a central bank to define its policy objective and its strategy clearly and to provide a stable and broadly predictable pattern of behaviour to the public. In addition, central banks should avoid pursuing an activist monetary policy, i.e. they should avoid attempts to fine-tune the economy. In general, the limited knowledge of the monetary transmission process favours a clear medium-term orientation in order to accurately assess the risks to price stability.

The current monetary and economic situation in the euro area

Let me finally turn to the current monetary and economic situation and its implications for monetary policy. As you are no doubt aware, the ECB has kept interest rates unchanged since the beginning of October last year. This policy reflects the fact that risks to price stability in the medium term have become more balanced over the past few months, although some factors which may pose upward risks still remain.

Starting with the first pillar of the monetary policy strategy of the ECB, monetary data for December 2000 confirmed the moderation of monetary dynamics, which has been observed since the spring of last year. The three-month average of the annual growth rates of M3, covering the period from October to December, stood at 5.0%, slightly lower than the 5.1% for the period from September to November 2000. Hence, the risks to price stability from the monetary side have become increasingly more balanced. However, some caution is still warranted, given the previous protracted period of upward deviations of M3 growth from the reference value of 4 1/2%.

Broadly similar indications are emerging from the second pillar. This year, real GDP growth may be somewhat weaker than last year, and inflationary pressures stemming from previously higher oil prices and a low external value of the euro may gradually disappear. Nevertheless, there is also need for some caution.

The external environment of the euro area is currently surrounded by a high degree of uncertainty. After several years of impressive economic growth in the United States, the slowdown in growth there may be more significant than previously anticipated. Obviously a considerably weaker economic performance of the United States, which accounts for slightly more than 20% of world GDP, would have implications for world economic growth. However, on the basis of the information available at present, it is likely that world economic activity will remain at an acceptable level this year. In addition, it should be borne in mind that the euro area itself is also a large domestic market - it is, in fact, the second largest in the world - accounting for over 15% of world GDP. Exports of goods and services only amount to around 17% of euro area GDP: this implies that the influence of external trade on real economic growth is limited. Instead, euro area economic activity is mainly influenced by domestic factors.

Economic growth in the euro area has recovered considerably since the second half of 1999. Real GDP growth is expected to have been around 3 1/2% in 2000, compared with an average real GDP growth of 2% in the 1990s.

Real GDP growth in the euro area has slowed down somewhat since the second half of 2000, as demonstrated in recently published GDP data and short-term indicators, such as industrial production and, to some extent, the European Commission's industrial confidence indicator. However, at the same time, this indicator, together with the capacity utilisation rate, have remained at a high level and continue to give a relatively favourable picture.

Regarding private consumption, the European Commission's consumer confidence indicator recovered on average in December and January, following a dip in the previous months. In particular, private households were more optimistic about the future economic situation as well as their own financial situation. The data confirm the view that the earlier decline in consumer confidence was mainly due to the adverse effects of the increase in oil prices until November 2000, which dampened private household real disposable income growth. Overall, consumer confidence has continued to remain at a high level, reflecting favourable financing conditions and improving conditions in the labour markets. The latter is indicated by a robust growth in employment and a further decline in the unemployment rate. In addition, tax reductions in a number of euro area countries can be expected to fuel domestic demand this year.

All in all, it seems likely that real GDP will continue to expand at a robust pace this year. Hence, there is reason to be optimistic with regard to further economic developments in the euro area.

Turning to price developments, inflation fell to 2.6% in December, down from 2.9% in November, reflecting the decrease in oil prices in euro terms. Provided that this drop in oil prices and the recovery in the effective exchange rate of the euro are sustained, the annual rate of consumer price inflation is expected to fall to below 2% in the course of the year. However, this may take some time. Over the short term, the process may be slowed down by the delayed impact of previous import price increases.

Given the present situation, potential second-round effects remain a risk to price stability. Against this backdrop, it is important to proceed with wage moderation. Moreover, it is essential that fiscal policy meet the obligations of the Stability and Growth Pact. Continuing progress in fiscal consolidation should be achieved by containing public spending growth, allowing for both a reduction in remaining budget deficits and an alleviation of the fiscal burden on corporations and private households.

Concluding remarks

Overall, it is fair to say that the first two years of the euro have been a success. At the start of Monetary Union, the economic environment in the euro area was still in the aftermath of the Asian and Russian crises, rendering considerable uncertainty to world economic development. At present, the economic situation in the euro area is much more favourable, even though uncertainties from the external environment have increased recently. Admittedly, consumer price inflation currently stands above 2%. However, this development is mainly due to direct effects stemming from the external oil price shock, which cannot be prevented by monetary policy. It is very positive for the credibility of the ECB that under these circumstances inflation expectations have remained contained, as reflected, for example, in financial market indicators and survey data. This shows that the ECB's stability orientation is properly understood by the markets and by the public at large.

I am also optimistic about the future. The maintenance of price stability over the medium term will contribute significantly to the achievement of sustainable economic growth and to the economic welfare of the population in the euro area. If other policy areas also play their part, we have reason to be confident about the future of the euro area.

Finally, I should like to draw your attention to one particular challenge which will take place this year or, to be more precise, at the end of this year: the introduction of euro banknotes and coins and the general changeover to the euro as the new unit of currency. As far as the Eurosystem is concerned, it is our responsibility to ensure that the printing of around 14.5 billion euro banknotes, representing a value of some EUR 650 billion, and the bringing into circulation of the banknotes and coins, is successfully completed. In order to achieve this, we have planned an information campaign, with the aim of familiarising those living both inside and outside the euro area with the new currency. Beginning on 1 September 2001, euro area banknotes and coins will be frontloaded to credit institutions, which will then sub-frontload them to professional groups (retailers, cash-in-transit companies and the cash-operated machine industry). From the second half of December 2001, the general public in several Member States will receive starter kits containing a mixture of denominations of euro coins in order to facilitate initial purchases in 2002. I am truly convinced that the visible introduction of the euro will be a decisive step in the further integration of the euro area, as well as in increasing the acceptance of the euro by the population of the euro area and abroad.