Christian Noyer: The stability-oriented monetary policy of the ECB

Luncheon speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the conference organised by HSBC CCF Securities, Paris, 6 September 2001.

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Ladies and Gentlemen,

I am very grateful for your invitation to speak today in Paris on the occasion of the forum organised by HSBC. As a contribution to today's discussion of strategies, I should like to explain the design of the monetary policy strategy of the ECB and how it helps the Governing Council of the ECB in its monetary policy deliberations and the communication with the public. Then, I should like to discuss the current monetary and economic situation and its implications for monetary policy. Finally, I would like to give you some information on the introduction of the new banknotes and coins.

Let me turn to the monetary policy strategy of the ECB. The primary objective of the ECB is to maintain price stability in the euro area. This objective has been chosen because price stability supports higher living standards through a number of channels. It enhances the transparency of relative prices and thereby fosters competition. Inflation risk premia that would be asked for by investors in the presence of uncertainty about inflation are minimised. Firms and individuals do not need to heavily invest in hedging against inflation and deflation, and thus can allocate their resources to productive uses. In an environment of price stability possible distortions of tax systems are reduced. The related improvement in the efficient allocation of production factors may help to enhance the production potential of the economy. Also from a social point of view, inflation is not welcome. It leads to a 'random' redistribution of wealth between economic actors, to the detriment of the most vulnerable.

Since the start of 1999, the ECB applies its monetary policy strategy, which is centred around a quantitative definition of price stability and the analysis of risks to price stability. This monetary policy strategy has helped the Governing Council to derive and explain monetary policy decisions. It has contributed a lot to the successful mastering of this task and has triggered academic debates whether elements of this strategy should be introduced by other monetary authorities.

The key element of the ECB's policy framework is the precise quantitative definition of price stability. It clarifies that the Governing Council aims to keep annual increases in the Harmonised Index of Consumer Prices (HICP) for the euro area below 2%. Moreover, the Governing Council announced that price stability according to this definition shall be maintained over the medium term. Thereby, it provides the public with clear guidance for inflation expectations. In addition, the ECB's transparent framework facilitates the process of accountability of the ECB by providing a yardstick against which its performance can be assessed.

The statement that "price stability is to be maintained over the medium term" acknowledges the existence of short-term volatility in prices, resulting from non-monetary shocks to the price level such as the effects of indirect tax changes or variations in international commodity prices. There are good economic reasons why monetary policy should be oriented towards the medium term. Monetary policy affects prices with "long and variable lags", so that a policy of fine-tuning the economy is, in practice, neither a viable nor a desirable option. It is evident that the ECB cannot be held responsible for short-term shocks to the price level, since it has little control over them. Rather, assessing the outcome of the monetary policy of the ECB over the medium term ensures a meaningful and genuine accountability.

Having a well-defined goal is vital. In addition, the ECB, like any other central bank, also requires an analytical framework which facilitates the achievement of this goal. The ECB's strategy recognises that, in an environment of change and uncertainty, no single model or view of the world is likely to be fully adequate to capture the ongoing economic processes and the implications for price stability.

The need to adopt a diversified approach to analysing and assessing information in an uncertain world was a main reasoning behind the adoption of the ECB's two-pillar strategy. The distinct, yet mutually-reinforcing perspectives of a complex and changing environment provided by the two pillars are the best tools with which the ECB can distil and master the information relevant for monetary policy-making.

Under the first pillar, the ECB assigns a prominent role to money. A broad array of aggregates, ranging from M3 to its components and counterparts, notably credit, are analysed in order to assess threats to price stability. Assigning a prominent role to money guarantees that the fundamentally monetary origins of inflation will not be neglected in the analysis driving monetary policy decisions.

The prominent role of money is signalled by the announcement of a reference value of 4½% for the annual growth of the broad aggregate M3. This reference value defines the rate of growth of M3 which is consistent with price stability over the medium term. The ECB has from the start explained that it will not react mechanistically to deviations of M3 growth from the reference value. Rather monetary developments always have to be analysed carefully in order to assess the information content they have for future inflation. This is because the money - price link is in essence a medium-term relationship, whereas short-term movements in monetary aggregates always have to be interpreted carefully.

In parallel, a wide range of other economic and financial indicators is assessed under the second pillar, in order to extract additional information which is not contained in monetary data, and to cross-check the evidence obtained from assessing monetary developments. Analysis within this second framework is intended to reveal the impact of a host of factors on price developments in the short to medium term, such as wage developments, fluctuations in commodity prices and exchange rates, confidence among consumers and producers, etc.

Under the second pillar, macroeconomic projections based on conventional models also play a role as a tool for organising and summarising existing information. In the light of the ECB's commitment to being a transparent institution, the ECB has published the Eurosystem staff macroeconomic projections since last December. However, the analysis carried out under the second pillar does not only involve the production of projections. The staff projections cannot, in practice, include the latest developments in all economic indicators. It is therefore useful to monitor individual indicators in parallel with producing the projections, not least because such analysis also provides an insight into the forces driving the projections. Moreover, under the second pillar of the ECB's strategy, the Governing Council also evaluates indicators of financial market expectations derived from financial yields and prices. The Governing Council also looks at forecasts for the euro area produced by international organisations and the private sector. All this information is assessed simultaneously by the Governing Council under the second pillar, and is complemented by the monetary analysis under the first pillar.

In the discussions leading to its policy decisions the Governing Council systematically incorporates the analyses conducted under both of the complementary pillars underlying the ECB's monetary policy strategy. It should be regarded as a strength of the strategy that multiple frameworks are embodied and the resulting need for decisions which are robust across different models of the economy becomes obvious.

A good understanding of the ECB's monetary policy in public enhances the effectiveness and fosters the credibility of the ECB's monetary policy. Experience collected over the time since the start of Stage Three of EMU suggests that the anti-inflationary credibility of the ECB is high. Indeed, long term inflation expectations have remained in line with price stability since early 1999.

Finally, let me briefly explain the Governing Council's assessment provided under the two pillars of the ECB's monetary policy strategy.

As regards the first pillar, growth in monetary aggregates has somewhat picked up in recent months. In the period May to July, the three-month moving average of M3 growth was 5.9%. However, this figure needs to be corrected for the upward distortion related to non-euro area residents' holdings of money market paper and short-term debt securities by non-residents of the euro area. According to preliminary estimates, these factors explain around three-quarters of a percentage point of annual M3 growth. Furthermore, the recent move in this figure is driven very much by the effects on money demand of some factors which are likely to remain temporary. First, the increase in the rate of growth of M3 over the past few months reflects a relatively flat yield curve and the recent weakness in stock markets, both of which made the holding of short-term deposits and marketable paper included in M3 attractive. Second, as it also reflects the fact that consumers needed a higher level of transaction balances to finance the past rise in energy and food prices, recent increases in M3 growth may be transitory and, hence, do not necessarily have implications for price stability in the medium term. Lastly, the annual rate of growth of loans to the private sector, although still high, has continued to decline over recent months.

As regards the second pillar, there are clear signals of lower inflationary pressure from the demand side. Recent data on economic activity indicate that real GDP growth in 2001 will most likely be lower than was expected a few months ago. The deceleration reflects both the global slowdown, which has affected euro area exports, and weaker than expected consumption growth owing to losses in real disposable income related to past increases in consumer prices. All these factors also had a negative impact on investment. This notwithstanding, over time, the expected decline in consumer price inflation, to which the strengthening of the exchange rate has contributed, should support the growth of domestic demand. Further positive effects on euro area economic growth are expected from the full impact of tax reductions in several euro area countries and the favourable financing conditions.

Turning to price developments, annual consumer price inflation in the euro area, as measured by the Harmonised Index of Consumer Prices (HICP), declined to 2.8% in July, from a peak of 3.4 % in May. A concern with regard to the outlook for price stability in the coming years has been the possible emergence of second-round effects, via wages, on the current level of consumer price inflation. The information available shows that wage moderation prevailed in the first quarter of 2001. At the current juncture, two factors support the view that this downward trend will continue in future. First, the slowdown in economic activity may contribute to containing inflationary pressure stemming from the labour market. Second, there are encouraging signs, such as those coming from data on consumer and producer prices, which confirm that the increase in consumer price inflation was temporary. In the absence of further unfavourable price shocks, it is likely that price stability will be restored in the not too distant future.

Against the background of lower inflationary pressure, the Governing Council decided on 30 August 2001 to lower the minimum bid rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility by 25 basis points respectively. It emphasised that it considers the new level of interest rates as compatible with the maintenance of price stability over the medium term, which at the same time, is an essential contribution to creating a favourable environment for sustainable economic growth.

At this juncture, let me also make some remarks about recent discussions on fiscal policy. For the euro to be successful, governments need to adhere strictly to the Stability and Growth Pact and achieve a budget position in balance or surplus. Under the present circumstances, the automatic stabilisers should only be allowed to work fully in those countries whose budget positions have achieved this sustainable level. Let me emphasise that a medium-term perspective is essential for the conduct of fiscal policies in all euro area countries. Short-term discretionary measures aimed at strengthening domestic demand risk having an unwelcome impact on the economy, not least on account of time lags. In addition, if such measures are not consistent with the Pact, they may undermine the credibility of the consolidation process.

Let me turn to the introduction of the euro. With the forthcoming introduction of euro banknotes and coins, it is sometimes forgotten that Europe has had a single currency since 1 January 1999. Therefore, let me recall that today most cash-less transactions in the euro area involve the euro as a currency (with the exception of retail payments). The euro is present on all major financial markets around the globe. Currency trading in euro has been going on for two and a half years. Shares are denominated in euro on most European stock exchanges. The next and final step will be the introduction of euro-denominated banknotes and coins on 1 January 2002.

The introduction of the new euro banknotes and coins is the final step which completes the creation of the single currency. With this changeover, the considerable benefits of the single currency will become apparent to European citizens. A natural advantage of the single currency is that it reduces transaction and information costs in the euro area. It enhances the function of money as a medium of exchange by lowering the costs typically associated with market transactions. Generally speaking, money is an important component of any market economy. In a complex exchange economy, money is an important means of achieving decentralised co-ordination between the plans and actions of economic agents across time and space. The function of money as a medium of exchange is significantly enhanced by enlarging the area in which a single currency is used as legal tender not least since this eliminates exchange rate uncertainty within the currency area.

The introduction of the new euro banknotes and coins in the euro area, which comprises around 300 million citizens, is in many respects a huge challenge. First, the launch of the euro banknotes requires an initial supply of about 14.25 billion banknotes – representing a value of around €641 billion – to be available by a fixed deadline. Second, the banking sector, security carriers, retailers and the cash-operated machine industry are closely involved in the preparations at an early stage, as a smooth cash changeover can only be achieved in a short period of time by systematic and co-ordinated interaction on the part of all the main participants. Third, the successful introduction of euro cash is preceded by a goal-oriented information campaign to prepare the general public and professional cash handlers in Europe for the new currency. The President of the ECB launched this campaign on 30 August and at the same time presented the details of the new banknotes to the public. This new currency which will be in some 100 days' time in our pockets, is our money, a tangible reality and a symbol of European integration in every sense of the word. The euro banknotes are produced with state-of-the-art security standards and combine many of the highly effective security features already used in the national banknotes of the euro area Member States together with some additional features. Finally, a series of legal and organisational measures is being taken to ensure both a successful currency changeover and unimpeded circulation in the future. Production of the euro banknotes started in July 1999. The euro banknotes are currently being produced by 15 different printing works throughout Europe, including the printing works of a number of national central banks (NCBs).

The role of the ECB can be described as that of a central co-ordinating, controlling and monitoring body, focusing in particular on the timely production of the euro banknotes and on the organisation of the changeover. Let me emphasise that both production and delivery of euro banknotes are on schedule. In most countries frontloading and sub-frontloading of euro banknotes and coins has already started and is well under way. Frontloading is the advance distribution of euro banknotes and coins to those credit institutions that are counterparties for monetary policy operations within the Eurosystem. Credit institutions can then sub-frontload euro banknotes and coins to professional groups (retailers, cash-in-transit companies, the cash-operated machine industry) provided that certain conditions are fulfilled. The most important condition is to guarantee that the euro banknotes will not be put into circulation before 1 January 2002.

Thank you for your attention.