Willem F Duisenberg: The first lustrum of the ECB

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the International Frankfurt Banking Evening, Frankfurt, 16 June 2003.

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Introduction

It gives me great pleasure to address such a distinguished audience today; even more so as it is not the first time I am speaking at the International Frankfurt Banking Evening.

On 1 June of this year, the ECB celebrated its fifth anniversary. Hence, In my speech today, I will focus on two topics. First, I will discuss some lessons from our experience of monetary policy in the euro area during the first five years of the ECB. Second, I will look ahead and elaborate on ongoing developments in the context to the Convention on the Future of Europe, which aims to lay the foundations for a Constitutional Treaty for the European Union.

ECB monetary policy-making in perspective

Starting with our experience of monetary policy, and, of course, speaking as an impartial observer, I can say that I am very satisfied with how the Governing Council of the ECB has functioned over the last five years in fairly difficult circumstances. Indeed, a lot has happened and it must be said that the first lustrum of the ECB was a fair “baptism of fire”. I am not going to bore you with a recap of the monetary policy decisions we have taken, or the reasons behind each of them, but will instead concentrate on seven or so features which, to my mind, can be considered as the main issues when reviewing our monetary policy experience.

Let me begin by making a few remarks on our **focus on price stability**. This focus is enshrined in the Treaty on European Union and is our mandate. It is so with very good reason. Long gone are the days when monetary policy was thought to face a long-term trade-off between inflation and economic growth. It is now globally acknowledged that maintaining a low and stable rate of inflation is the best contribution that monetary policy can make to economic welfare.

The ECB has pursued its mandate of maintaining price stability with vigour and determination. The public has understood this. Inflation expectations, as measured by survey data or by financial market indicators, have always remained consistent with our definition of price stability. This is all the more remarkable as the ECB had no track record at the beginning while it was faced with the euro area economy being hit by repeated upward price shocks. As a result of all these shocks, HICP inflation has been above - and sometimes significantly above - 2% for quite some time. But inflation always bounced back following these shocks and today the outlook for price stability is once again favourable.

A second related point I would like to mention is the **medium-term orientation** of our policy. As a central bank, we only affect prices with long lags and we cannot steer trends in prices with high precision. Our focus on the medium term helps to avoid overly ambitious attempts to fine-tune inflation developments. You might ask what “medium term” means exactly. It is certainly not a fixed time horizon, as some have argued. Experience in recent years has taught us that flexibility in this respect is very important. From this point of view, the ECB’s monetary policy strategy is different from pure forms of inflation targeting.

This leads me to my third issue, which is that one cannot simply rely on a **single inflation forecast** to conduct monetary policy successfully. Experience suggests that it can be very misleading to summarise the assessment of medium-term inflationary pressures in one single figure, even when a measure of statistical error is attached to it. Unfortunately, monetary policy is not so simple and the repeated significant forecast errors by all major institutions over the last few years provide evidence of this. Indeed, I agree with Alan Greenspan who once said that central bankers should be less reluctant to admit that they sometimes do not know.

Instead of relying on a single forecast, our monetary policy strategy emphasises this fundamental uncertainty. Our strategy builds on several forecasts and indicators and includes a cross-check of the information from the economic analysis, which is relevant from the short to medium-term perspective for inflation, with that from the monetary analysis, which is important for the medium to long-term outlook.

In this respect, the fourth point that I would like to discuss today is that over the last few years we have seen that **monetary analysis** is not only an important, but also a complex business. I have no doubt that inflation is a monetary phenomenon over the long term and that we are right in attributing a prominent role to monitoring monetary developments in our monetary policy strategy.

A fifth point I would like to make is that it was difficult to gauge the effects of **global interdependencies** when we began to conduct the single monetary policy. What we have learnt, in particular, is that global linkages go well beyond the international trade channel, which was traditionally considered to be the main, if not the only channel through which economic shocks were transmitted. Moreover, more shocks - such as those associated with the introduction of new technologies and those of a political nature - have increasingly become global in nature.

Related to this - and this is my sixth point - we have learnt that **sharp asset price fluctuations** may be very important for shaping economic trends. In recent years we have witnessed extraordinary developments in capital markets. Initially, exceptional optimism about potential output growth and talks of a “new economy” drove stock prices to sky-high levels.

The “new economy” euphoria was sowing the seeds of less positive developments even before it actually burst. It seems to have been accompanied by a rising short-termism of corporate managers, which in turn was accompanied by corporate malpractice and also pushed firms to over-invest, especially in the IT and telecommunications sector. The subsequent large fall in equity prices and the revelation of corporate malpractice had a series of negative consequences, including an increase in leverage ratios of non-financial corporations, a decline in the value of collateral, increases in risk premia, and certain firms experiencing difficulties in obtaining external finance. All of this may still be part of the reason for the weak consumption and investment activity, and thus the slow pace of economic growth in the euro area that we are now observing.

To cut a long story short: monetary policy obviously has to take into account the public and financial market sentiment in assessing the risks to price stability over the medium term. Central banks must monitor financial market developments very closely in order to figure out what the consequences are for the outlook for price stability over the medium term, but they must not target asset prices.

Finally, and this is my last point on monetary policy, I would like to stress that **effective communication** is an all-important requirement for successful monetary policy. However, as we have learnt over the last five years, it is no easy business. I am sure you will appreciate that communication is particularly difficult in the context of the euro area, with so many different traditions and languages.

Over time, we have seen a significant improvement in public understanding of our communication of our monetary policy strategy and our monetary policy decisions. Evidence of this is that our monetary policy decisions have been very predictable, as reflected in money market indicators, which I rate as a highly positive development. Indeed, we want to be, and we have to be, well understood in order to be effective in our policy. And, as you were able to see from our recent clarification of the ECB’s strategy, we continue to strive for even more effective communication.

The future of the ECB

Let me now turn to the **Convention on the Future of Europe** and the future institutional status of the ECB. Celebrating the fifth anniversary is, of course, a good opportunity for us to look ahead. Where will the ECB be in five years time? What kind of challenges will it face? What kind of environment will it be confronted with?

Today we are very much aware that the constitutional construction of the European Union is in a process of evolution. The Convention has more or less wrapped up its deliberations and its President, Valéry Giscard d’Estaing, will present the draft of a new “Treaty establishing the Constitution” to the leaders of the Member States in a few days time.

As the central bank of the European Union, the ECB has followed the work of the Convention with great interest over the past one and a half years. The ECB welcomes all efforts to further the construction of a united Europe. A European Union with effective, functioning and transparent structures and processes, capable of meeting the expectations of its citizens, and equipped to assume international responsibility commensurate with its size and importance, would complement and further bolster the success of Economic and Monetary Union (EMU). Throughout the five years of its existence, the ECB has stated that a strong euro is good for a strong Europe. I would now like to add that a strong Europe is good for a strong euro.

If the European Union is re-writing its rulebook by giving itself a Constitution, does this mean profound changes to the provisions relating to the ECB and to monetary union in general? Throughout the process of drafting the Constitution, the ECB has consistently advocated that the economic constitution of the EU - the basic set of rules and provisions for EMU as laid down in the Maastricht Treaty - is sound both in terms of the objectives set and the allocation of responsibilities between different actors and levels of government. The Convention appears to have followed a similar reasoning, as it appears that the future Constitution will take over the provisions relating to EMU in an essentially unchanged form. The single monetary policy is, by its very nature, indivisible and is thus centralised; hence it remains an exclusive competence of the Union. The task of conducting monetary policy, as well as all other central banking tasks, has been assigned to an independent central bank with a clear primary objective of maintaining price stability. In addition to the ECB, the ESCB is also mentioned in the first part of the Constitution, thus acknowledging the federal nature of the monetary authority of the European Union and its *sui generis* character. Finally, the more specific provisions concerning monetary policy in the current Treaty as well as the Statute of the ECB and the ESCB will remain unchanged and form part of the constitutional texts of the Union.

By contrast, budgetary and other economic policies will remain under national competence in the future Constitution, in recognition of the fact that the vast majority of “public goods”, such as defence, for which revenues are raised and subsequently dispensed, are still provided at the national level. That said, the draft Constitution also prescribes a close co-ordination of economic policies within the Union. I very much welcome the fact that the fundamental features of the current set-up of EMU have been preserved. After all, the stability of the institutional architecture is a crucial element of the credibility of the single monetary policy and the public’s confidence in our currency.

Concluding remarks

Clearly it is now up to the governments of the Member States to move forward in the forthcoming Intergovernmental Conference and give the final form to the text prepared by the Convention. If I, as a central banker, am allowed to present my assessment, I would argue that the Convention has done a very good job of incorporating the substance of the EMU chapter into the new Constitution, while also introducing clarifications, additions and updates in the current texts where necessary and appropriate. What I do miss is that the Convention has not taken over our suggestion to incorporate somewhere in the text the notion of ***Eurosystem***, which stands for the core concept of our central banking system, i.e. the ECB and the national central banks of the member states that have adopted the euro. The Eurosystem is not mentioned in the Treaty as it stands, nor in the draft-Constitution. Conclusion: we still have some work to do....!!!

Thank you for your attention.