Mr. Duisenberg elucidates the European System of Central Banks' stability-oriented monetary policy strategy

Speech by the President of the European Central Bank, Dr. W.F. Duisenberg, at the Institute of European Affairs in Dublin on 10/11/98.

1. Introduction

On January 1 - in only fifty-two days - Stage Three of Economic and Monetary Union (EMU) will commence. A single monetary policy will be adopted for the entire euro area - a continent-wide zone of eleven sovereign states and almost 300 million people.

The advent of the euro offers great opportunities for Europe and Europeans. Transaction costs will be reduced. Pricing will become more transparent between European countries, encouraging greater competition and innovation in goods and financial markets. A truly single market will be created.

Above all, though, Monetary Union offers a unique opportunity to establish and maintain price stability throughout the eleven countries that will comprise the euro area from 1 January 1999. I am convinced that by meeting the Treaty mandate and fulfilling the unambiguous commitment of the Governing Council of the European Central Bank (ECB) to maintaining price stability we shall ensure that the single monetary policy makes the greatest possible contribution towards raising the standard of living of Europe's citizens and improving growth and employment prospects. Price stability, consequently, is at the core of the "stability culture" that we are creating in Europe.

Today, I should like to describe how we intend to meet our primary objective in the unique - and potentially difficult - circumstances attending the birth of the euro. At the heart of our approach is the "stability-oriented monetary policy strategy" recently adopted by the Governing Council and announced to the public last month.

First and foremost, this monetary policy strategy is designed to ensure that the Governing Council is presented with the information it requires to make effective monetary policy decisions. The Council must act in a forward-looking and pre-emptive manner, changing interest rates to contain inflationary or deflationary pressures before such trends become entrenched.

Monetary policy is most effective when it is credible, that is, when the public is convinced that monetary policy will successfully maintain price stability over the medium term. Indeed, aside from enjoying your Irish hospitality, bolstering this conviction is the main purpose of my speech. Reassuring you and the wider public of the Governing Council's commitment to price stability - and thereby building up the credibility of our new "stability-oriented monetary policy strategy" - will not only make my own job easier over the coming years. It will also increase the overall benefits of maintaining price stability in the euro area as a whole.

Speeches such as this are important. They illustrate the commitment of the European System of Central Banks (ESCB) to openness and accountability in its decision-making. Openness and accountability are necessary complements to the independence of the ESCB, on which the credibility of the single monetary policy rests. Moreover, the monetary policy strategy must be clear and transparent so that there is no confusion or ambiguity about the objective of monetary policy and how this objective will be achieved.

To this end, the ESCB's stability-oriented strategy has been designed and presented in a very straightforward, realistic and, if I may say so, honest way. These features are central to clarity and transparency. They complement the many other efforts we have made - and will continue to make -

to ensure that our communication with the public is open and transparent. Statements will be released and press conferences, including question and answer sessions, will be held immediately following Governing Council meetings. Regular monthly publications will be produced by the ECB. Discussion papers and technical analysis by the ECB staff will be published for professional review and scientific assessment. In all these regards, the ESCB is exceeding the reporting requirements laid down in the Maastricht Treaty, which are already among the most stringent applicable to any central bank.

Furthermore, in these articles and other presentations, we shall address various economic issues facing Europe, not least the issue of the high level of unemployment. In doing so, we shall make the best possible use of the knowledge of experts throughout the ESCB and ensure that this expertise is available to the wider public and the policy-making community.

In this context, let me emphasise that the Governing Council of the ECB is very concerned about the unacceptably high rate of unemployment in the euro area. However, an inflationary monetary policy would not solve Europe's serious unemployment problem. On the contrary, an inflationary policy would not only unacceptably flout the Maastricht Treaty; a Treaty, let me remind you, that has been ratified by all the Member States of the European Union and endorsed by the public in referenda in several countries, including Ireland. An inflationary monetary policy would almost certainly lead to higher unemployment in the medium run, as long-term interest rates would rise and the benefits of price stability would be lost. Such a policy would therefore be entirely counterproductive. Let me be very clear: in the interest of all European citizens, the Governing Council is determined to protect price stability. The ESCB's independence is a means to facilitate the achievement of this goal. Only by preserving price stability and thereby creating the stable environment required for continued higher employment and growth, can the European System of Central Banks (ESCB) serve the public and address the public's understandable concerns.

In describing the ESCB's stability-oriented monetary policy strategy today, I shall emphasise the twin principles of clarity and transparency that are vital in order to establish the credibility - and therefore ensure the success - of the single monetary policy.

Monetary Union is a unique event. It is likely to prompt considerable changes in economic behaviour and the institutional structure. These changes will be to the benefit of Europe's citizens, not least as the benefits of price stability are reaped. Nonetheless the inevitable and not totally unpredictable changes in behaviour prompted by the introduction of the euro create uncertainty. This uncertainty will complicate the task of implementing the single monetary policy.

Against this background, the ECB Governing Council has chosen a distinct monetary policy strategy, one that reflects the special circumstances that it faces at present. Given a natural desire to build on the success of national central banks in bringing inflation down to its current low level during the convergence process, the strategy ensures as much continuity as possible with the existing strategies of the national central banks (NCBs) of the participating Member States. Nevertheless, the chosen strategy takes into account to the extent necessary the unique situation created by the transition to Monetary Union.

I shall proceed by describing the three main elements of the stability-oriented strategy. First, I shall discuss the quantitative definition of the ESCB's primary objective, namely price stability. Second, I shall outline the prominent role played by money in the overall strategy. Third, I shall describe the analysis of a wide range of other financial and economic indicators that will enter the policy discussion. Finally, I shall conclude by arguing that the stability-oriented strategy adopted by the

ESCB is, in the present circumstances, both clearer and more transparent than any of the alternatives. In consequence, I am confident of its future success.

2. The quantitative definition of price stability

The Maastricht Treaty assigns the ESCB the primary objective of maintaining price stability. In the interest of accountability, the Governing Council of the ECB has decided to publish a quantitative definition of price stability, against which its success in fulfilling the Treaty's mandate can be sensibly judged by the public.

In this context, at its October meeting the Governing Council of the ECB agreed that "price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%".

In this way, the Governing Council has clearly and unambiguously defined its objective. If and when we do not meet this objective, we are obliged to explain why this is the case and what we are going to do about it. Let me emphasise the over-riding priority we attach to this objective. This priority is not only a consequence of our legal obligations under the Treaty. It is also rooted in our belief – supported by both decades of experience and a substantial body of theoretical and empirical research – that maintaining price stability in the euro area is a pre-requisite for a sustainable and lasting improvement in the standard of living of Europe's citizens and can lay the foundation for improving growth and employment prospects in the future.

The definition we have published is clear. In particular, a specific price index is identified with which to assess the maintenance of price stability. The HICP for the euro area was chosen because it is both sufficiently harmonised across the different countries of the euro area at the start of Stage Three and consistent with the public's usual focus on consumer prices.

Using the index "for the euro area" highlights that euro area-wide developments, instead of specific national or regional factors, will be the only determinants of decisions regarding the single monetary policy.

As I have emphasised in the past, this definition signals the aversion of the Governing Council to both inflation and deflation. The phrase "below 2%" clearly delineates the rate of inflation in the HICP deemed consistent with price stability. The wording "year-on-year increases" implies that decreases in the HICP - that is to say deflation in the measured price index - would not be considered consistent with price stability.

The Governing Council also announced that "price stability is to be maintained over the medium term". In doing so, it realistically acknowledged that disturbances to the price level can occur in the short run - for example, those caused by changes in indirect taxes or commodity prices - that cannot be controlled by monetary policy of the ESCB. Such factors may lead to occasional falls in the HICP, or occasional increases above 2%. These are quite normal and consistent with a meaningful definition of price stability. By focusing on the medium term, the ESCB's monetary policy will ensure that these transitory deviations from the definition do not become sustained over the medium term.

By maintaining price stability over the medium term, the appropriate forward-looking and medium-term orientation is imparted to monetary policy. This will ensure that policy reactions to threats to price stability are measured and deliberate. Such actions will not introduce unnecessary instability or uncertainty into the economy, while nevertheless ensuring that price stability - and the attendant benefits - are maintained.

The prominent role of money in the ESCB's monetary policy strategy

Let me now turn to the role money will play in the ESCB's stability-oriented monetary policy strategy.

Ultimately, inflation is a monetary phenomenon. Assigning a prominent role to money within the overall stability-oriented strategy therefore guarantees that the monetary origins of inflation will not be neglected in the regular economic and financial analysis driving monetary policy decisions. Moreover, money is a visible "nominal anchor" for monetary policy that will help to stabilise the public's medium-term inflation expectations, enhancing the credibility and effectiveness of monetary policy.

To signal the prominent role attached to money, the Governing Council of the ECB will announce a quantitative reference value for monetary growth. In this regard, some commentators have assumed that the ESCB has adopted a conventional monetary target, but simply called it by a different name. However, before announcing a formal intermediate monetary target, certain conditions have to be met. These requirements have been met in the past in several euro area countries, and successful monetary targeting strategies have been pursued. However, one must recognise that, at present, the evidence as to whether these technical preconditions will be satisfied for the euro area as a whole in Stage Three is inevitably sparse. Monetary Union will cause changes in the financial system and economic behaviour, as ten different currency zones are merged into the single euro area. As I mentioned in my introduction, most of these changes will be of great benefit to individuals and firms in Europe. However, these behavioural and institutional changes are likely to change the relationship between money, interest rates and prices that has been observed in the past.

Consequently, a realistic alternative to a monetary target - that is, the reference value for monetary growth - will be announced. As I mentioned earlier, this reference value ensures as far as possible continuity with successful monetary strategies pursued in the euro area in the past. Nevertheless, it is a different approach that reflects the special circumstances facing the ESCB at the start of Stage Three.

This reference value will have two key features:

- first, it will be derived in a manner that is clearly consistent with - and serves the purpose of - price stability;
- second, it will be constructed such that, in the absence of special factors or other distortions, deviations of monetary growth from the reference value will signal risks to price stability.

The relationship between actual monetary growth and the pre-announced reference value will therefore be regularly and thoroughly analysed by the Governing Council. Where deviations occur, an explanation will be sought. If this explanation points towards a threat to price stability, monetary policy will react appropriately in order to address this threat. However, in contrast to the reaction that would normally follow under a conventional monetary targeting regime, interest rates will not be changed in an attempt to correct deviations of money growth from the reference value over the short term.

The Governing Council would not wish to react in a mechanistic fashion to monetary developments, precisely because the signals implied by the money data could be scrambled by the technical uncertainties I have mentioned. By announcing a reference value and openly explaining how it will be used, the Governing Council is presenting its monetary policy strategy to the public in a way that reflects the manner in which it discusses policy itself. This is the essence of transparency.

A number of issues remain to be finalised with regard to the quantitative reference value for monetary growth. First, the broad monetary aggregate for which the reference value will be announced has to be defined. Second, the reference value for monetary growth for 1999 will have to be derived and published. Progress on these two important issues is well under way and I anticipate a final announcement by the Governing Council in December.

1. A broadly-based assessment of the outlook for price developments in the euro area

Although the monetary data contain information vital to monetary policy-making, monetary developments alone will not, of course, constitute a complete summary of all the economic information necessary to enable appropriate policy decisions to be taken. In the ESCB's stability-oriented monetary policy strategy, money is accorded a prominent - but not an exclusive - role.

There is a clear need for the Governing Council to look at a wide range of other economic and financial indicators. Consequently, in parallel with the analysis of monetary growth in relation to the reference value, a broadly-based assessment of the outlook for price developments and the risks to price stability in the euro area will also be undertaken. This assessment will systematically analyse all the other information about the economic and financial situation, ensuring that the Governing Council is as well-informed as possible when making its monetary policy decisions.

Outside the ESCB, some commentators have labelled this broadly-based assessment an "inflation forecast". Failure to publish "the" inflation forecast is seen by some as contrary to the principle of transparency. I am afraid that both views are flawed. Allow me to explain why.

While it is true that accurate forecasts can contribute to the success of an appropriately forward-looking monetary policy, the ESCB should not be judged on, or held accountable for, the accuracy of its internal forecasts. Rather, its performance in maintaining price stability in the medium term should be used by the public to judge the success of the ESCB's policies. Consequently, the publication of a forecast is only important in so far as it helps to achieve price stability through increasing the clarity and transparency of the policy-making process. In this regard, there are some important problems with publishing a single "official inflation forecast".

Relying on a single forecast that attempts to summarise all the information available from a wide range of indicators would be misguided. The Governing Council will not wish to be presented with a single number to which it will have to react mechanistically, if at all. In contrast, the Governing Council will want to know the economic reasons behind the projected risks to price stability. The appropriate monetary policy response to a threat to price stability will depend on the nature of the threat. The Governing Council can only understand the nature of the risk if it is presented with a full set of data. From these data, it can attempt - with the help of various staff analyses - to identify the nature of the disturbance to price stability. Having identified the threat, an appropriate policy response can be selected and implemented.

Even with the best intentions, making an inflation forecast requires numerous subjective judgements about developments in the economy. Adjustments will need to be made to forecasts to allow for the behavioural and institutional changes caused by the transition to Stage Three. Even purely "model-based" forecasts reflect the preferences of those who constructed the models. Against this background, publishing an inflation forecast would obscure rather than clarify what the Governing Council is actually doing. The public would be presented with a single number intended to summarise a thorough and comprehensive analysis of a wide range of indicator variables. However, such a summary would inevitably be simplistic. Moreover, because publishing a single inflation forecast would be likely to suggest that monetary policy reacts mechanistically to this forecast, publication might mislead the public and therefore run counter to the principle of clarity.

The publication of an inflation forecast might be problematic in other ways. If the ESCB were to publish a projection based on the assumption of unchanged interest rates, then, when inflationary or deflationary pressures arose, the projection might be interpreted as suggesting that price stability is actually in jeopardy. However, this would be very misleading. The Governing Council of the ECB is fully committed to the maintenance of price stability according to its published definition and would change monetary policy in order to address and contain the threat to price stability. However, the publication of the forecast itself might introduce an independent destabilising effect into private inflation expectations, inadvertently undermining the credibility of the single monetary policy, making price stability harder to maintain and reducing the overall benefits of doing so. As I have said in the past, under certain circumstances the publication of the inflation forecast itself may lead to some form of implicit indexation of wages, imparting a costly self-sustaining momentum to such forecasts.

If the ESCB were to publish an inflation forecast that incorporated the effects of its policy changes, rather than assuming that monetary policy was unchanged, then it would inevitably forecast price stability over the medium term. This follows from the unambiguous commitment of the Governing Council to meeting its primary objective of maintaining price stability. Publishing such a forecast might be reassuring, but it would not be very informative.

Clearly, the Governing Council could have decided to announce some form of inflation forecast and justify policy decisions by reference to it. Interest rate increases or decreases could then be explained on the basis that the inflation forecast pointed to threats to price stability. However, this presentation of monetary strategy to the public is likely to involve a circular argument. For example, interest rate increases would be justified on the basis that the inflation forecast pointed to an inflation rate higher than that consistent with price stability. However, critical observers might soon argue that the inflation forecast was above the target precisely because there was a perceived need to raise interest rates. Simply publishing a forecast does not explain why interest rates need to be changed. Moreover, as I have said, simply presenting a forecast to the public does not explain how the conclusion that a rate rise is required has been reached. On both grounds, publishing the forecast does not enhance the transparency and clarity of the strategy.

The strategy we have chosen at the ESCB avoids this danger. Based on this strategy, the Governing Council will inform the public regularly of its assessment of the monetary, economic and financial situation in the euro area. Moreover, when policy decisions are made, the reasoning behind specific decisions - including the economic rationale according to which judgements have been made - will be communicated to the public. By presenting the analysis that is actually driving the policy decisions, the ESCB is being both clear - since this analysis is informative about policy changes - and transparent - since the presentation to the public will reflect the type of discussion I expect to occur in the Governing Council itself.

2. Conclusion

In the present circumstances, the Governing Council has decided that following any mechanical policy rule to determine monetary policy in the euro area would be inappropriate. Putting “all our eggs in one basket” would be especially dangerous at the start of Stage Three, given the uncertainties that we face. Indeed, a mechanistic approach is unlikely to produce good policy decisions under any circumstances. To pretend otherwise to the public would be misleading and dangerous.

Nevertheless, the ESCB's monetary policy strategy must be clear and transparent if we are to convince the public of our commitment to maintaining price stability and our ability to do so. We must be seen to be operating in a solid and coherent framework that leads to consistent and effective monetary policy decisions.

The stability-oriented monetary policy strategy adopted by the Governing Council of the ECB offers just such a framework. Having been designed to respect the principles of clarity and transparency, I am confident that this strategy will be successful. By maintaining price stability in the euro area, the ESCB will thus lay part of the necessary foundation for Europe's future economic stability and prosperity.