Mr Duisenberg reviews the first year of experience with the Eurosystem's monetary policy strategy

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the joint congress of the Federations, EUROFINAS and LEASEUROPE, held in Paris on 11 October 1999.

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Almost exactly one year ago, on 13 October 1998, the Governing Council of the European Central Bank (ECB) announced the main elements of its stability-oriented monetary policy strategy. As we reach the first anniversary of this announcement, it seems appropriate to reflect on our experiences over the last year and review the lessons that we have learnt. I am particularly grateful for your invitation to speak here today because of the opportunity it provides to present such a review.

Let me begin by clarifying some of our terminology, which still may not be familiar to everyone. "Eurosystem" is the name we use to describe the European Central Bank and the eleven national central banks of those countries that introduced the euro on 1 January 1999. We call the geographical area defined by these eleven countries the "euro area". The monetary policy implemented by the Eurosystem is sometimes simply called "the single monetary policy".

The design of the Eurosystem's monetary policy strategy required an appreciation of the environment in which the Eurosystem operates. This environment imposes certain constraints on the single monetary policy. It is useful to distinguish three categories of constraints: economic, institutional and practical. First, the Eurosystem must acknowledge the capabilities and limitations of monetary policy implied both by general economic principles and by the structure of the euro area economy. Second, the Eurosystem must act in accordance with the mandate, tasks and powers assigned to it by the EC Treaty. Finally, the monetary policy strategy of the Eurosystem has to reflect practical constraints, many of which arise because of the uncertainties created by the regime shift associated with the transition to Monetary Union.

I should like to address each form of constraint in turn, starting with general *economic issues*. Among central bankers and economists, overwhelming agreement exists that there is no long-run trade-off between real activity and inflation. Attempting to use monetary policy to raise real economic activity above its sustainable level will, in the long run, simply lead to ever higher inflation, not faster economic growth. The best contribution monetary policy can make to sustainable growth and employment in the euro area is to maintain price stability in a credible and lasting manner, allowing the considerable benefits of price stability to be reaped.

When price stability prevails over the medium term, the relative price signals on which the market mechanism relies are not obscured by changes in the general price level. The market is therefore able to allocate scarce resources more efficiently to their most productive uses. The costs inflation would otherwise impose by exacerbating the distortions in tax and welfare systems are avoided. As inflation risk premia are reduced, long-term real interest rates decline, thereby improving the financing conditions for investment. Through these and other channels, the current environment of stable prices is contributing to the growth and employment potential of the euro area.

This discussion sheds light on what is surely the greatest economic challenge facing the euro area at present, namely the need to reduce the current unacceptably high level of unemployment. There is a broad consensus that unemployment in the euro area is overwhelmingly structural in nature. Monetary policy cannot solve this problem, although by maintaining an environment of price stability it certainly helps. The level of structural unemployment depends on the flexibility and efficiency of labour and product markets, not on the stance of monetary policy.

National governments bear the main responsibility for structural economic reform designed to enhance market flexibility and improve the allocation of resources. Wage moderation can also have a significant beneficial impact. The ECB will continue to cajole governments into implementing necessary structural reforms, but the final hard decisions – and I recognise that they are hard decisions, since the considerable benefits of structural reform only become apparent with time – lie with the national authorities.

The success of past structural reform is, however, already visible in the European Union. In those countries where appropriate structural reform has been implemented and wage growth has been moderate, unemployment is either low by euro area standards or is falling relatively rapidly. These experiences offer important lessons for other countries in the euro area.

The *institutional framework* for European monetary policy created by the EC Treaty reflects these economic realities. Most importantly, the Treaty clearly assigns the single monetary policy the primary objective of maintaining price stability in the euro area. To facilitate achievement of this goal, the ECB and the national central banks and their decision-making bodies have been accorded a high degree of institutional independence in order to protect monetary policy decisions from undue external interference.

The mandate to maintain price stability should not be seen in isolation. The Treaty assigns several other duties and tasks to the ECB. This notwithstanding, there is no doubt of the overriding importance attached to the primary objective of price stability. To illustrate this point, the Treaty requires – if I may quote from Article 105 – that the Eurosystem "*without prejudice to the objective of price stability, … shall support the general economic policies in the Community, with a view to contributing to the achievement of the objectives of the Community*". These Community objectives include "sustainable and non-inflationary growth" and "a high level of employment". The qualification "without prejudice" leaves no room for ambiguity about the status of price stability as the overriding objective of the Eurosystem and the single monetary policy.

The Treaty also clarifies that the primary objective of exchange rate policy shall be price stability (Article 3). This is an important feature that will help the ECB achieve its mandate. In many respects, monetary and exchange rate policy can be regarded as two sides of the same medal. A different objective for exchange rate policy would not have been compatible with the overriding commitment to maintain price stability, which the Treaty has placed upon monetary policy.

Finally, let me address a number of more *practical issues* associated with the transition to Monetary Union itself. In designing the Eurosystem's strategy, the Governing Council of the ECB recognised the new circumstances faced by monetary policy in the euro area. Where there were previously eleven open, generally small economies, there is now one large, relatively closed single currency area. The challenges implied by this transformation in the landscape of monetary policy are profound.

Given that the euro area did not exist as a single currency area before January 1999, one obvious problem was the need to establish a statistical data set. Much has been achieved, particularly in the areas of money and banking and balance-of-payments statistics. Nevertheless, compared with national central banks in the past, we still do not always have at our disposal the long historical time series of economic indicators, based on harmonised statistical concepts, which are required for detailed analytical studies. However, the quality and availability of current statistics on the euro area has increased significantly over the last few quarters. This process of improving the quality and the availability of statistical data covering the euro area will continue.

These economic, institutional and practical constraints were important elements that led to the specific design of the stability-oriented monetary policy strategy. The strategy is intended to fulfil two important roles. *First*, it structures the monetary policy making process so that the ECB Governing Council, the decision-making body on monetary policy, is presented with all the information and analysis it requires to take appropriate decisions. *Second*, the strategy ensures that policy decisions, including the economic rationale on which they are based, can be presented in a clear, coherent and consistent way to the public. By providing a stable framework for making and explaining monetary policy decisions, the strategy bolsters the credibility and effectiveness of the single monetary policy.

Given the practical constraints I have just outlined, at this early stage it would clearly be unwise for the ECB to rely mechanically on the signals offered by a single indicator or forecast in order to take monetary policy decisions. Indeed, such a simplistic approach to monetary policy making is unwise in all circumstances. Our knowledge of the structure of the euro area economy and the indicator properties of specific variables – although rapidly improving – is simply too sparse. In this respect, it has to be acknowledged that the introduction of the euro constitutes a structural break. Such a break may have an impact on the behaviour of economic agents, thus impacting on macroeconomic relationships. This potential impact concerns money as well as all other variables.

The monetary policy strategy selected by the Governing Council therefore embodies a different and more robust approach, consisting of three main elements which were announced a year ago.

First, the primary objective of monetary policy has been quantified with the publication of a definition of price stability, which serves as a guide for inflation expectations and provide a framework against which the Eurosystem can be held accountable. This definition illustrates our aversion to both inflation and deflation, since it defines price stability as annual *increases* of *below 2%* in the Harmonised Index of Consumer Prices (HICP) for the euro area. 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.

Second, to maintain price stability according to this definition, monetary developments are closely monitored in relation to a quantitative reference value for monetary growth. The first reference value has been set as an annual growth rate of 4½% for the broad aggregate, M3. Consistent with the medium-term orientation of the strategy, this reference value was derived so as to be consistent with price stability over the medium term, using assumptions concerning medium-term developments in real GDP and the velocity of circulation of money.

Third, in parallel with this monetary analysis, a broadly based assessment of the outlook for price developments in the euro area is undertaken. This assessment encompasses a wide range of indicator variables, including inflation projections produced both inside and outside the Eurosystem.

Using the information revealed by this analysis, every two weeks the Governing Council assesses the level of short-term interest rates that best serves the maintenance of price stability over the medium term. On the basis of this strategy, I am confident that the Governing Council has so far taken – and will continue to take – the necessary monetary policy decisions to maintain price stability over the medium term.

I believe that my confidence is well founded. Our announcement of the strategy was generally well received by the public and the financial markets reacted favourably. Nevertheless, I am aware that some criticisms of the Eurosystem's strategy have been made. One year after our first announcement of the strategy, it seems appropriate to address a number of these criticisms.

Some observers have criticised the strategy as *"asymmetric"*. In other words, they argue that the Eurosystem is more concerned about inflation than it is about deflation. In their view, such asymmetry will impose a drag on the overall performance of the euro area economy as a whole because monetary policy will be overly restrictive on average, and risks triggering a damaging deflationary spiral in some circumstances. These assertions are often based on the perceived lack of a quantitative lower bound to the definition of price stability, which is contrasted with a clear upper bound of 2%.

I reject this criticism. The use of the word "increases" in the definition imposes a floor of at least zero for the lower bound. The absence of a specific numerical value for the lower bound honestly reflects the uncertainties we face, for example concerning the existence and magnitude of a so-called measurement bias in the HICP. At present, there are no reliable indications about the size of this bias which relates, inter alia, to the fact that the quality of goods improves over time and the composition of the basket underlying the HICP is not immediately adjusted to reflect different spending patterns as relative prices of different products change. Against this background of uncertainty, it would have been arbitrary to announce a specific figure for the lower boundary. Rather, in view of the existence of potential measurement bias, we take the view that we should get more concerned as the outlook for price developments approaches zero, but not to limit our concern to a specific figure.

Even though the measurement bias is uncertain and does not allow us to specify an exact lower boundary for price stability, I should stress that the upper limit of the definition of price stability is clearly above all plausible estimates of such measurement bias. This clearly demonstrates that we are certainly not asymmetric in the sense that we would be more concerned about inflation than deflation.

These are largely technical issues. Let me state categorically, as I have often done in the past, that neither prolonged inflation nor prolonged deflation in the euro area would be deemed by the Governing Council to be consistent with the maintenance of price stability. I cannot see how our commitment to symmetry could be stated more clearly. Our decision to lower interest rates in April 1999, so as to address downside risks to price stability that had emerged during the first quarter, was a clear practical demonstration of this commitment.

Others criticise the "*prominent role for money*" in our strategy, which is reflected by the announcement of a reference value for M3 growth and our thorough analysis of the monetary aggregates. Critics argue that M3 growth should not play a prominent role in our strategy and should not influence monetary policy decisions in a meaningful way.

I do not agree with these criticisms of the role of money in our strategy. There is little doubt that monetary aggregates in the euro area exhibit a close relationship with inflation. Last month, the ECB published an empirical study which demonstrates that M3 has a stable relationship with the price level in the euro area over the medium term. No other single non-monetary indicator variable has such a stable relationship with price developments at this horizon. Therefore monetary growth needs to be analysed very closely by the Governing Council and we believe that monetary developments constitute an invaluable compass for monetary policy decisions aimed at price stability over the medium term.

However, it is well known that the short-run relationship between money and prices is more complex. Consequently, monetary policy cannot react mechanically to every deviation of actual monetary growth from the reference value. Nor should monetary policy makers be held accountable for keeping monetary growth close to the reference value at a specific point in time. The reference value is not a target – interest rate decisions do not attempt to return M3 growth to 4½% in the short term. Rather deviations of monetary growth from the reference value need to be carefully analysed, in parallel with a thorough assessment of other indicators. The implications of the deviations for price developments over the medium term should be extracted. Monetary policy should then act on the basis of the information revealed so as to maintain price stability at the medium-term horizon.

Our interest rate decisions, our internal analysis of monetary developments and our presentation of monetary developments to the public are all consistent with this explanation of the role of the reference value in the overall monetary policy strategy. I would simply add – as I have done on several occasions in the past – that our interpretation of monetary developments is currently further complicated by the uncertainties surrounding the data itself that I alluded to a moment ago. However, I would like to take this opportunity to remind you that the uncertainties surrounding the monetary data are no greater than those surrounding other economic variables.

In this respect, it is of interest to note that the ECB has even been criticised by some observers for *not* paying sufficient attention to money!

The Eurosystem has also been criticised for being a secretive institution that does not meet the required standards of *transparency and clarity* in its conduct of monetary policy. Some criticise our strategy for not being sufficiently simple, arguing that we should focus only on one indicator, be it money or an inflation forecast. To these critics, I can say that our strategy is honest. It reflects the complex environment we are living in – an environment in which policy decisions cannot be simply related to one information variable.

Others argue that we do not release sufficient information about our analysis. These critics claim that the credibility of the single monetary policy has suffered as a result. I would agree that the effectiveness of the Eurosystem's policy actions will depend, in large part, on the credibility of the single monetary policy. Transparent and accountable policy making can help to build reputation and hence credibility. In turn, transparency and accountability rely on clear and effective communication between the Eurosystem and the public.

In this regard, the Eurosystem faces an especially formidable task. With each policy announcement or Monthly Bulletin, the Eurosystem must speak to eleven audiences in all the different official languages of the European Union. Such a situation is unprecedented. Moreover, each of the countries in the euro area has its own distinct monetary history and heritage. This diversity of language, history and culture across the euro area raises further communication challenges for the ECB.

In contrast to the assertions of our critics, we think that we have risen well to this challenge. A key feature of the Eurosystem's communication policy is the monthly press conference given by the ECB Vice-President and myself, usually immediately following the first Governing Council meeting of each month. During these press conferences, I make an introductory statement summarising the Council's discussions and conclusions before answering questions from journalists. In substance, this statement is similar to what other central banks call "minutes". As far as I am aware, no other central bank regularly communicates in such a prompt and open manner with the public immediately after its monetary policy meetings. Giving these press conferences immediately after the Governing Council meetings also ensures that decisions and information are disseminated rapidly and even-handedly across the entire euro area and beyond.

These press conferences are a tangible expression of the Eurosystem's commitment to be open, transparent and accountable in its conduct of monetary policy. They are supplemented by our appearances before the European Parliament, by our Monthly Bulletin, Annual Report, working paper series and numerous speeches and presentations such as my remarks here today. In my view, the Eurosystem's commitment to openness should not be in doubt.

Turning to another point, critics of the Eurosystem have argued that the single monetary policy has focused too closely on cyclical developments, in contrast to the public commitment made to a medium-term orientation. These criticisms are supported by the claim that the interest rate cut in April 1999 was made so as to *support employment and growth prospects in the short term*.

Let me be clear. The single monetary policy has had, and will continue to have, an appropriate medium-term orientation, in line with the strategy I described a moment ago. In this respect, monetary policy must always remain focused on the maintenance of price stability over the medium term. In April 1999, downward risks to price stability were appearing, which stemmed from the cyclical slowdown that occurred in the aftermath of the financial turmoil in emerging markets during mid-1998. These downside risks made it necessary for the Governing Council to act. Interest rates were cut. The focus on the primary objective of price stability driving this decision does not exclude, however, that – given risks to price stability are very often related to cyclical developments – in many cases the policy action required to maintain price stability may also help sustain real activity. The Governing Council's decision to lower interest rates in April 1999 clearly helped to sustain confidence and thereby real activity in the short term. Nevertheless, this decision was made to ensure the maintenance of price stability over the medium term.

Of course, central bankers should and do welcome the opportunity to help sustain the real economy and employment – even if the sustenance provided is only temporary. However, we must not raise expectations that the short-term impact of necessary monetary policy actions on real activity will always be favourable. Situations will certainly arise when monetary policy does face a short-term trade-off between adverse developments in real activity on the one hand and deviations from price stability on the other. In such a situation, the overriding priority accorded to maintaining price stability must be made absolutely clear. Any ambiguity on this point will simply endanger the credibility, and therefore the effectiveness, of the monetary policy response.

This leads naturally to a discussion of whether the Eurosystem does and will pursue *an "activist" monetary policy*, where interest rates are changed frequently in response to the "news" revealed by new data releases. We have a medium-term outlook and, in contrast to some other central banks, we do not have a point target for inflation rates. We therefore do not think it is useful to be overly activist and to react immediately to any "news" that comes in. Monetary policy affects the economy with "long and variable lags" and is therefore particularly ill suited to "fine-tuning" cyclical developments in the short run. However, we will not hesitate to act promptly should this be necessary to maintain price stability over the medium term.

Before concluding, I would briefly like to address another topical issue, namely the implications of *asset price developments* for the determination of monetary policy. In our view, asset prices are important indicators for the conduct of monetary policy, but they should not be seen as an objective in themselves. Asset prices are determined in part by real economic factors, which cannot be affected by monetary policy over the medium term. Stock prices will depend on current and expected corporate profits. Real estate prices depend on current and expected demographic trends, tax regimes, zoning laws and so forth. The Eurosystem does not know better than the market how these factors will evolve in the future and therefore what level of asset prices is appropriate.

Furthermore, attempts by a central bank to influence asset prices raise the danger that "moral hazard" is introduced into asset markets. It would not be desirable if the public were to believe that the central bank would act to prevent dramatic falls in asset prices, thereby underwriting accumulated capital gains. On the contrary, for the smooth functioning of asset markets it is important that proper incentives are given to investors to assess the values and risks inherent in the underlying assets.

Of course, that is not to say that central banks should ignore asset price developments in their assessment of economic conditions. Within the Eurosystem's monetary policy strategy, asset prices are thoroughly and carefully monitored. Asset prices are important indicators as they offer an insight into private expectations of future price and economic developments. They also have important macroeconomic effects, for example on wealth, consumption, the demand for credit and the strength and stability of the financial sector in the euro area. Through each of these channels, asset prices can affect the outlook for price developments in the euro area.

While the ECB does not target asset prices, let me emphasise that, if the single monetary policy is successful in achieving its primary objective so that price stability is maintained over the medium term, other things equal one would expect asset prices to be more stable than would otherwise be the case. In fact, reducing the volatility of asset prices might be considered one of the many beneficial side effects of maintaining price stability over the medium term. However, beyond this possibly limited contribution, monetary policy cannot prevent potentially large swings in asset prices. Asset price stability is not an objective of the single monetary policy in and of itself.

Let me conclude. I believe we have made a successful start to Monetary Union, and that the strategy announced by the Governing Council 12 months ago has played an important part in this success. At the same time, we should recognise that monetary policy alone cannot address all of the economic challenges facing the euro area. In particular, it cannot reduce the euro area's unacceptably high level of structural unemployment. However, by focusing on the maintenance of price stability, monetary policy makes its best contribution to area-wide growth and employment prospects. After the experience of the last year, I am confident that the monetary policy strategy adopted by the ECB Governing Council a year ago – and the monetary policy decisions that have been based on it during the last nine and a half months – serve the fulfilment of this objective.