# Mr Noyer: Monetary policymaking in the euro area

Speech delivered by Mr Christian Noyer, Vice-President of the European Central Bank, at Pareto Fonds' 2000 Economic Forum, Oslo, on 23 March 2000.

*     *     *

Ladies and gentlemen,

It is a pleasure and an honour for me to speak here at the Pareto Fonds' 2000 Economic Forum in Oslo. The economic conferences organised by the Pareto Fonds have an outstanding reputation for presenting a unique opportunity for investors, economists and policymakers to conduct an in-depth exchange of views on current issues of monetary policy.

In January 1999 the euro was successfully launched as the single currency for the 11 countries comprising the euro area. For more than a year, the Eurosystem, which includes the European Central Bank (ECB) and the 11 national central banks (NCBs) of the countries which have introduced the euro, has been in charge of the single monetary policy for the euro area. Of course, it is much too early to make a detailed assessment of the achievements of the single monetary policy. Nevertheless, the first 15 months of the euro have been encouraging and there are good reasons to look to the future with optimism. Owing to very careful technical and conceptual preparations, both the monetary policymaking process and the implementation of monetary policy decisions have functioned efficiently from the very outset. At the same time, there can be no doubt that there is room for further improvement and that important challenges still lie ahead.

In my remarks today, I shall describe the main features of monetary policymaking in the euro area, focusing in particular on the monetary policy objectives of the Eurosystem, the stability-oriented monetary policy strategy and on some of the communication issues raised by the strategy. Moreover, I shall briefly highlight the current economic outlook for the euro area.

### Price stability as the primary objective of the single monetary policy of the Eurosystem

The Treaty establishing the European Community clearly states that the primary objective of the single monetary policy shall be to maintain price stability. Furthermore, the Treaty requires that, without prejudice to the objective of price stability, the Eurosystem shall support the general economic policies in the European Community with a view to contributing to the objectives of the Community. The latter include, inter alia, sustainable and non-inflationary growth and a high level of employment.

The Treaty therefore establishes a clear sequence of objectives for the monetary policy of the Eurosystem, with price stability unambiguously being the sine qua non. Such an assignment of tasks to a central bank is nothing extraordinary. On the contrary, it reflects the consensus which has emerged over the last two decades to the effect that maintaining price stability is the best contribution monetary policy can make to sustainable and non-inflationary output growth and employment perspectives.

The belief that monetary policy should be geared towards price stability is firmly rooted in economic theory which clearly demonstrates the costs of inflation, both in terms of allocative inefficiencies and arbitrary redistribution effects. At the same time, these arguments suggest that maintaining price stability in itself contributes to higher growth and employment. Several empirical studies have concluded that, across a large number of countries, it is on average those with lower inflation which appear to grow more rapidly.

While there is a widespread agreement on the benefits of price stability, it is less clear exactly what price stability means. In the context of its stability-oriented monetary policy strategy, the Governing Council of the ECB defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". According to this definition, price stability "is to be maintained over the medium term".

The phrase "below 2%" clearly delineates the upper bound for the rate of measured inflation in the HICP, which is consistent with price stability. At the same time, the use of the word "increase" in the definition clearly signals that deflation, i.e. prolonged declines in the level of the HICP, would not be deemed consistent with price stability.

The main reason for not aiming at a measured inflation rate of zero is what is known as the "measurement bias", which can exist in consumer price indices. These biases arise mainly from changing spending patterns and quality improvements in those goods and services which are included in the basket used to define a specific price index. Such biases cannot always be fully corrected in the construction of price indices. The measurement bias typically causes consumer price indices (CPIs) to overstate slightly the "true" rate of inflation. While the measurement bias of the HICP is likely to be lower than that observed in the national CPIs of the countries comprising the euro area, we cannot completely neglect it. Nevertheless, there are as yet no conclusive studies on the size of the measurement bias of the HICP for the euro area. This is the main reason why the Governing Council of the ECB did not announce an explicit lower bound for its definition of price stability.

In the literature there are also some economic arguments in favour of a slightly positive rate of inflation. First, it has been argued that the existence of downward nominal rigidity in wages implies that inflation is required to ensure downward flexibility of real wages, thereby allowing resources to be allocated efficiently across different economic sectors in response to changes in technology and consumer preferences. Second, it has been put forward that a modestly positive rate of inflation is required to ensure that monetary policy can always engineer negative real interest rates, should this be required. There are good and well-known reasons not to overstate these arguments. At the same time, the definition of price stability chosen by the Governing Council allows for moderately positive inflation below 2%.

The Governing Council underlined the fact that price stability is to be maintained over the medium term. In the short term, the inflation rate can be influenced by one-off factors outside the control of the central bank, such as changes in indirect taxes or movements in commodity prices. Moreover, monetary policy impulses exert their influence on the overall price level only with considerable time-lags. Hence, monetary policy cannot avoid short-term deviations from inflation rates consistent with price stability.

**The two pillars of the monetary policy strategy of the Eurosystem**

The intrinsic challenge for central banking is the need to look ahead. Were monetary policy only to react when inflationary pressures are already visible, it would always be too late, as interest rate changes show their full impact on prices only after around six to eight quarters. Moreover, it would have to react much more strongly than in the event of a timely action. The past experience with stop-go policies, widespread in the 1960s and 1970s, clearly illustrates the negative side effects in terms of a high volatility of inflation and output.

A forward-looking monetary policy requires a structured approach in order to interpret and synthesise all the information relevant for an assessment of the outlook for price developments; in other words, it requires a well-founded monetary policy strategy. The strategy of the Eurosystem is based on two pillars, the first being a prominent role for money and the second a broadly based assessment of the outlook for price developments.

To give money a prominent role in its monetary policy analysis is quite a natural thing for a central bank geared towards price stability to do, because inflation is ultimately a monetary phenomenon. The important role assigned to money is reflected in the announcement of a reference value of 4½% for the annual growth of the broad monetary aggregate M3. Current M3 growth is analysed and interpreted in relation to this reference value. Under normal conditions, substantial or prolonged deviations of monetary growth from the reference value would signal risks to price stability over the medium term. For the euro area, this relationship is empirically well-founded. The available econometric evidence suggests the existence of a stable relationship between M3, the euro area price level and a small number of other area-wide macroeconomic variables. Moreover, there is good evidence with regard to leading indicator properties of M3 for future price developments.

While there can be no doubt about the relevance of monetary growth for inflation in the medium term, short-term changes in the stock of money may be influenced by factors unrelated to future spending and future inflation. Thus, the Eurosystem does not react mechanically to short-term deviations of monetary growth from the reference value. Instead, monetary developments are analysed very carefully in order to extract their information content for future inflation. If this analysis clearly were to suggest that monetary developments indicate a threat to future price stability, monetary policy would respond in a manner appropriate to counter the risk.

Although the monetary data contain information vital to informed monetary policymaking, on their own they will not normally constitute a complete summary of all the economic information required to set an appropriate monetary policy for the maintenance of price stability. Thus, 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 play a major role in the Eurosystem's strategy. This assessment is made on the basis of a wide range of variables which have leading indicator properties for future price developments, including, inter alia, wages, unit labour costs, bond prices, the yield curve, fiscal policy indicators, various measures of real activity, price and cost indices.

Let me take this opportunity to stress that the Governing Council of the ECB considers the euro exchange rate an important indicator within the second pillar of the Eurosystem's strategy. It is closely monitored and influences monetary policy decisions, as it can have implications for the outlook for price stability in the euro area. Changes in the exchange rate can influence the outlook for price developments both directly, through their impact on import prices, and indirectly, through their effects on trade. Against this background, the prolonged depreciation of the exchange rate of the euro since the beginning of 1999 is indeed a cause for concern and is being carefully taken into account in our discussion on the appropriate monetary policy stance.

Another element of the second pillar is macroeconomic forecasts. Given the forward-looking nature of the stability-oriented strategy, the Eurosystem follows closely the forecasts prepared by international organisations, market participants and others. In addition, it also produces its own forecasts. Forecasts are an indispensable tool for efficient information processing. They help to summarise and synthesise a large quantity of information which may otherwise become too unwieldy to form a sensible basis for policy discussion. At the same time, however, it should be recognised that the role of forecasts in the Eurosystem's monetary strategy is clearly limited. It certainly cannot be compared with that played in the context of inflation targeting. An inflation forecast can never be a sufficient statistical summary of all the information which policymakers require in order to take appropriate monetary policy decisions. To give only one example, it is extremely hard to integrate the information relating to monetary developments in a meaningful way in macroeconomic forecasts. Furthermore, it is often crucial to understand the nature of the factors which affect future price developments in order to assess the risks to price stability in the medium term. Thus, one can certainly not expect the Eurosystem to react to inflation forecasts in a mechanical way.

One criticism which is frequently raised by external observers refers to the complexity of the strategy just described. I agree that our strategy is complex but this honestly reflects the complexity of the monetary policy environment of the Eurosystem. While a forward-looking monetary policy is by definition complicated, its complexity is reinforced by the fact that the Governing Council of the ECB has to assess the monetary policy situation for a large and diverse single currency area consisting of 11 different countries. Moreover, owing to the impact of the introduction of the euro on the behaviour of economic agents and on the evolution of the institutional environment, we are faced with a relatively high degree of uncertainty with regard to the economic relationships which are relevant for monetary policy. Finally, the database for area-wide statistics is still relatively narrow by comparison with what central banks are accustomed to, at least in the industrialised world. Against this background, the two-pillar strategy of the Eurosystem has the advantage of being relatively resilient to these different forms of uncertainty.

**Issues of communication policy**

It is widely acknowledged today that communication policies belong to the core tasks of any central bank. For some years now, transparency has been one of the catchwords of central banking. This is closely related to the fact that, with more and more central banks becoming independent, the issue of accountability has gained equal importance. Accountability is in turn facilitated by a high degree of transparency. Not only those institutions to which a central bank is formally accountable, but also market participants and the public at large can make an assessment of the situation more easily if a central bank pursues its primary objective in an appropriate way. Hence, a high degree of transparency also facilitates the creation of credibility and, via its impact on the expectation-forming process, increases the efficiency of monetary policy.

Against this background, the Governing Council of the ECB has committed itself to being open, transparent and accountable for its decisions and its performance vis-à-vis the European public and the European Parliament, the public's elected representative. We are well aware of the fact that, because of both the complexity of the Eurosystem's monetary policy and the plurality of the audiences - which are accustomed to different communication forms - to which it is addressed, extraordinary efforts are required to explain the monetary policy considerations of the Governing Council on a regular basis in the most transparent way possible. While trying hard, we have certainly not yet overcome all the teething problems in this regard. All of us, however, are determined to continue to strive for improvement and I am convinced that we will make further progress in speaking with only one voice.

Often, however, the critics of the Eurosystem's communication policy do not refer to concrete situations, but claim that the Eurosystem's general approach to communication is inherently lacking in transparency. In this context I have the impression that the whole discussion regarding the transparency of monetary policy has become rather narrowly focused, associating transparency only with very specific communication tools, namely the publication of minutes and of inflation forecasts. It is sometimes forgotten that central banks have various instruments at their disposal for informing the public in an honest, clear and understandable way of the considerations and motivations underlying their monetary policy decisions.

One major tool of the communication policy of the Eurosystem is the press conference which the President of the ECB and I hold regularly following the first Governing Council meeting of each month. On these occasions, the President makes an introductory statement, in which he explains the decisions of the Governing Council on the basis of its assessment of the latest information on monetary, financial market and other economic developments. In my view, the introductory statement is very similar to what other central banks call summary minutes. This statement is followed by a questions and answer session, giving the journalists the opportunity to question the President or myself on any issue. This press conference provides a forum for presenting policy decisions as promptly as possible. The fact that some academics also recommend this procedure to other central banks can certainly be regarded as a positive assessment of our approach.

Another key instrument of our communication policy is the ECB Monthly Bulletin. The Monthly Bulletin is intended to provide the public with a thorough assessment of the economic situation as well as with articles covering topical issues important for the single monetary policy. Moreover, speeches such as this one today and other public appearances of members of the Executive Board, for example at hearings of the European Parliament, are an important channel of communication with the public. The ECB also participates actively in academic debate. Finally, a lot of information is accessible on the ECB's website.

All in all, the information supplied by the ECB goes beyond the requirements of the Treaty establishing the European Community. Against this background, it is not clear to me which additional relevant information academics and financial market participants hope to obtain from the publications of minutes and voting records. On the contrary, there is a non-negligible risk that focusing too much on individual words and deeds, i.e. the voting behaviour, is likely to obscure the clarity and coherence of the Council's policy signals. Moreover, the publication of voting records could lead to pressure being brought to bear on the governors of the NCBs by national politicians and interest groups. This, in turn, could endanger the euro area focus which all members of the Governing Council committed themselves to right from the outset, as well as the open and productive character of our discussions.

With regard to the calls for a publication of inflation forecasts, I should like to stress that, in order to be a helpful communication tool, the publication of forecasts requires extremely careful preparation. Not only must it be guaranteed that the forecasts are of sufficient quality, the public also has to be educated on how to read a forecast. A misunderstanding of the fundamental assumptions underlying a forecast or a misinterpretation of the role of the forecast in the context of the overall strategy can easily lead to a situation where the interpretation of the Governing Council's monetary policy decisions is not facilitated, but complicated. This is why the Eurosystem decided not to begin publishing forecasts from the very beginning of Stage Three.

**Monetary and economic developments in the euro area**

Let me now turn to the monetary and economic developments in the euro area. Exactly one week ago, on 16 March 2000, the Governing Council decided to raise the ECB interest rates by 25 basis points. This decision addressed the upside risks to price stability as signalled by both pillars of the monetary policy strategy. Last week's increase in ECB interest rates followed the interest rate decisions taken on 4 November 1999 and 3 February 2000 and continued the policy of countering these emerging upside risks to price stability in a timely manner. Thereby, it contributed to maintaining the favourable outlook for the euro area economy.

The following factors contributed to the latest interest rate decision. With regard to the first pillar, the three-month average of the annual growth rates of M3 exceeded the reference value of 4½% throughout 1999 and in January 2000. The prolonged deviation of M3 growth from the reference value signalled the existence of ample liquidity in the euro area. This is especially true when seen in conjunction with the continued strong growth of credit granted to the private sector, at an annual rate of around 10%.

With regard to the second pillar, most indicators and forecasts pointed to increasing upward pressures on consumer price inflation over the medium term. The strong rise in oil prices and the downward movement of the exchange rate of the euro in the past put upward pressure on import costs and producer prices. In the context of a strong cyclical upswing, these developments could, via second-round effects, have lasting effects on consumer price inflation.

As expected, consumer price inflation saw a further increase in the first two months of this year, with annual HICP inflation reaching 2.0% in February, after 1.9% in January and 1.7% in December 1999. The rise this year is largely accounted for by a further increase in oil prices and its effect on energy prices in the HICP. It is reinforced by base effects from declining oil prices at the turn of the year 1998/99. Oil prices increased further in early March, and in so doing will continue to place upward pressure on consumer prices in the short term.

The past movements of the exchange rate of the euro have increasingly become a cause for concern for price stability through their effect on import prices and producer prices. In the first half of March, the nominal effective exchange rate was 12.2% below the level recorded for the first quarter of 1999.

Overall, the upward pressures on consumer price inflation were regarded to have become greater and more protracted than previously foreseen. Against this background, the interest rate steps taken can be understood as pre-emptive measures aimed at maintaining price stability in the medium term.

Currently, the prospects for strong economic growth are very favourable. The strengthening of economic activity in the euro area in the second half of 1999 was confirmed by a first estimate of euro area real GDP growth for the fourth quarter of 1999. Real GDP is estimated to have increased by 0.9% quarter-on-quarter, following an increase of 1.0% in the previous quarter. In addition, the latest survey data indicate a continued improvement in economic activity. Area-wide industrial confidence increased further in the first two months of this year; it has now recovered from the effect of the slowdown in 1998-99 and stands again at the previous peak of April 1998. Moreover, the Purchasing Managers' Index signals improved business conditions in the manufacturing sector. The cyclical upswing should extend well into 2000 and continue thereafter. This is also confirmed by the available forecasts, which indicate a real GDP growth of slightly over 3% in 2000, reflecting both the favourable external environment and buoyant domestic demand. As for 2001, the economic expansion in the euro area is generally expected to continue at a similar pace.

In this environment, employment is expected to increase further and the still very high level of unemployment should continue to fall. Thus far, recent wage growth has been moderate and the same applies for actual wage settlements to date. It remains important not to jeopardise the expected improvements in economic conditions and labour market prospects through inappropriate wage settlements. In fact, wage moderation would help both to contain inflation in the euro area and lead to further progress in employment creation.

With regard to fiscal policies, the current upswing provides a good opportunity to comply more quickly with the objectives of the Stability and Growth Pact, and thereby to add substantively to the favourable economic conditions.

Let me conclude by stressing that economic conditions and prospects for the euro area appear to be better at present than at any time in the past decade. Growth is strong, employment is expected to increase further and the still high level of unemployment should continue to fall. Maintaining price stability and pursuing structural reform is the foundation for a sustained period of strong economic expansion and a lasting process of job creation.