Christian Noyer: Monetary policy formulation in the euro area

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the "Monetary Policy and the Markets" conference of the National Association for Business Economics, Washington, DC, 21 May 2001.

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Introduction

Ladies and gentlemen,

It is a pleasure, and a very great honour, to have been invited to address this special meeting of the National Association for Business Economics and to present the monetary policy of the ECB before this distinguished audience of business economists and policy-makers. The theme of the conference, "Monetary Policy and the Markets" is of the greatest interest – I believe – both to market participants endeavouring to discern and assess central banks' policy directions, and to the ECB, which, since its creation almost three years ago, has been assigning a prominent role to transparency and openness in its policy-making.

In my brief remarks today, I will first elaborate on the institutional set-up of the ECB and its objectives. Against this background, I will then attempt to explain the ECB's decision-making process as it is structured by our monetary policy strategy.

The institutional set-up and the objective of the ECB

The body collectively responsible for monetary policy decisions in the euro area is the Governing Council of the ECB, which consists of the ECB's President and Vice-President, the remaining four members of the Executive Board of the ECB and the Governors of the national central banks of those Member States that have adopted the euro as their currency.

The Executive Board is responsible for the preparation of the meetings of the Governing Council and the implementation of the decisions the Governing Council takes. In particular, the Executive Board instructs the national central banks on the operations to be completed in accordance with the Governing Council's directions, making sure that the entire process develops in a consistent and fully harmonised manner.

The Treaty establishing the European Community assigned to the ECB the maintenance of price stability in the euro area as the primary objective and unambiguous mandate. Rooted in the long-standing experience of the participating national central banks, there rests the conviction that it is with the credible and lasting maintenance of price stability that the ECB could best enhance the welfare of EU citizens. Given the uncertainties surrounding the monetary policy transmission mechanism that arise from the complexity and the continuous evolution of economic behaviour and institutional structures, the ECB is ill-suited to fine-tune economic developments. Attempts to support growth and employment by deviating from a monetary policy needed to maintain price stability would prove detrimental over longer horizons, thereby decreasing welfare and undermining the credibility of the single monetary policy. On the contrary, by focusing on its mandate and therefore avoiding both prolonged inflation or prolonged deflation, the ECB creates the stable environment in which appropriate structural and fiscal polices may promote output potential effectively.

To support and safeguard the pursuit of price stability, the Treaty endowed the ECB with a high degree of institutional independence, and in order to ensure transparency and accountability, it imposed on the ECB extensive reporting requirements.

The definition of price stability and the two pillars of the ECB's strategy

The complexity of the monetary policy transmission mechanism requires that the preparation, discussion and presentation of policy decisions be placed in a coherent clarifying framework. This is the task of the monetary policy strategy that is designed both to grant the policy-making of the

Governing Council a clear and consistent structure, and to provide the most suitable vehicle for communication with the public.

The monetary policy strategy chosen by the Governing Council ensures a comprehensive assessment of the economic situation, of the size and nature of the shocks hitting the euro area and of the related risks to price stability.

The quantitative definition of price stability constitutes the first feature of this strategy. The announcement of a numerical definition has been devised to enhance clarity, anchor expectations and offer a yardstick against which the ECB can be held accountable. The Governing Council defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2%". The upper bound of 2% is in line with the practice of participating national central banks before the start of Stage Three of Economic and Monetary Union (EMU). It enables the existence of a possible positive measurement bias in the HICP to be taken into account and creates a "safety margin" which helps ensure that negative rates of "true" inflation are avoided. The headline HICP is the indicator chosen as the preferred measure to quantify our primary objective because this is the homogeneous statistic that most closely approximates the "true" basket of private households' consumption in the euro area. While core measures of inflation that exclude the most volatile items are also regularly monitored for the purpose of a comprehensive analysis, the headline HICP is the variable on which we focus as our objective. The Governing Council also emphasised that price stability has to be maintained over the medium term. This reflects the need for our monetary policy to have a forward-looking, medium-term orientation. It also acknowledges that short-term volatility in prices owing to non-monetary shocks cannot be controlled by monetary policy and that monetary policy should therefore only be held accountable for price developments over a longer horizon.

It is important to recognise the role of the definition of price stability in the conduct of monetary policy. The Governing Council attempts to set the ECB's interest rates in a way that makes, conditional on the available information, the maintenance of price stability over the medium term in the euro area most likely.

It is widely acknowledged that central banks are called on to operate in an environment characterised by substantial uncertainty, not only with regard to current and future developments, but also concerning the actual functioning of the economy. This is particularly true in the context of the euro area where the regime shift entailed by the introduction of a single currency may affect economic behaviour and institutional structures. Under these conditions it is crucial to ensure that policy decisions be robust and all-encompassing. Therefore, the ECB not only acts with a forward-looking orientation, but also relies on a number of models, approaches and on a judgement appraisal.

The ECB designed a two-pillar structure for its strategy, with the objective of capturing and providing all of the relevant pieces of information on the euro area economy for the assessment of the Governing Council, thus enabling it to take its monetary policy decisions on the basis of full information. The first pillar foresees a prominent role for money, while the second envisages the analysis of a wide range of other economic and financial indicators.

The ECB devoted the first pillar of its monetary policy strategy to the appraisal of monetary developments and models that accord an important role to monetary and credit developments. This recognises the fact that inflation is ultimately a monetary phenomenon and allows to take advantage of the stability that characterises the relationship between broad monetary aggregates and the price level in the euro area. As a form of visible public commitment, the ECB also announced a reference value for the rate of growth of the monetary aggregate M3 that is consistent with its definition of price stability.

The Governing Council regularly receives a comprehensive analysis of current developments in monetary and credit aggregates. The information revealed by the analysis of monetary developments has proved until now to be an important and reliable guide for monetary policy decisions.

Under the second pillar of its monetary policy strategy, the ECB regularly monitors a broad set of non-monetary economic and financial variables, such as wages, unit labour costs, fiscal policy statistics and financial market indicators like stock prices and exchange rates. Most of this analysis focuses on cost pressures and on the interplay between supply and demand in the goods and labour markets. It also helps to ascertain whether shocks to the euro area economy and the resulting risks to price stability have an external or domestic origin, are of a temporary or permanent nature, and arise from the supply or demand side. Within the framework of the second pillar, the Eurosystem staff also produce macroeconomic projections which are published in the ECB Monthly Bulletin twice a year.

The macroeconomic projections elaborated by the Eurosystem staff do not represent the ECB's predictions of the most likely macroeconomic outcomes, but are built on the assumption of unchanged short-term interest rates and exchange rates of the euro. It is important to recognise that the Eurosystem's projections are produced on the basis of models that do not assign a relevant role to money and that there is also a host of other economic and financial indicators whose information could not be adequately conveyed by a simple figure or a statistical range.

In its decision-making the Governing Council therefore assesses the staff's projections together with all the other information under the second pillar, in conjunction with the monetary analysis developed within the first pillar. It is important to understand that the process of monetary policy formulation of the ECB is not centred on any forecast or projection and thereby departs from the practice followed by inflation-targeting central banks. The monetary policy decisions of the ECB have not responded mechanistically in the past, and will not do so in the future, to deviations of staff's inflation projections from any numerical target. The Governing Council, moreover, does not take any responsibility for the staff's projections which, as with forecasts produced by other institutions, are regarded as just one of the inputs into its deliberations. Given the uncertainty and different views about the appropriate model of the economy, it would not be productive for the Governing Council to produce its own single projection. The Governing Council instead focuses directly on setting policy rates, taking into account all information, and the uncertainty surrounding this information, in such a way that price stability can best be maintained over the medium term.

The robust and cross-checking assessment of information which characterises our two-pillar strategy has proved so far to be providing the Governing Council with the analytical support most suitable for the conduct of monetary policy in the complex and dynamic euro area environment. It is in fact with the pursuit of price stability under a forward-looking orientation that it can best safeguard and guarantee the conditions for favourable economic development in the euro area.

The financial markets, well-known for their pitiless judgement, have been confirming the credibility of our monetary policy. The developments of long-term interest rates have in fact been in line with our objective of maintaining price stability. This is not an insignificant achievement and we are committed to not putting it at risk.