Willem F Duisenberg: Challenges to the ECB's monetary policy

Speech by Dr Willem F Duisenberg, President of the European Central Bank, upon receiving the European Banker of the Year Award on behalf of the Governing Council of the ECB, Frankfurt, 16 May 2002

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Introductory remarks

Lady Mayor, Karl-Otto, Andrew, distinguished guests, ladies and gentlemen,

On behalf of the Governing Council of the European Central Bank, may I say that it is a special honour to receive the European Banker of the Year Award for 2002. The Council, which in two weeks' time will have been directing monetary policy for three and a half years, is proud to be the recipient of this prestigious award.

Since it was set up in June 1998, the Governing Council has discussed and deliberated in an atmosphere of collegiality and consensus. The search for broadly shared resolutions within the Council has ensured that a balanced judgement could be reached regarding the true state of the euro area, which covers a vast geographical area and comprises highly diverse national economies. The Council's consensual approach has fostered a long-term perspective and preserved continuity with our past. Seeking and obtaining a broad consensus on policy decisions and then explaining them carefully to the public on the basis of euro-area aggregate evidence has a threefold effect. It shields Governing Council members from pressures originating in their home countries; it imposes a discipline on monetary policy by having a continuous, multilateral check of time consistency and policy direction within the Council; and it counters any public suspicion that a national bias may inform policy decisions.

Internal governance has been an essential tool in the response to the many challenges confronting the ECB since its earliest days. At the start of Economic and Monetary Union we were faced with the extraordinary task of having to conduct policy with limited area-wide data, with several conventional statistical indicators still under construction and, of course, with the euro area undergoing a major regime shift. Moreover, we were hard pressed - following the Asian and Russian crises in 1997 and 1998 - to handle a difficult and unpredictable situation which some thought would spiral further downwards. And at the same time we had to attend to the unique task of laying the foundations for our future action, thereby completing the work that had been initiated by the European Monetary Institute. The ECB had to be guided towards full possession of the necessary economic details about a new and unique monetary area with an economic weight comparable to that of the United States.

So it must have come as a surprise to many that the birth of the euro in January 1999 went so well. Indeed, it was a resounding success. The transition to the euro was virtually free of technical faults. We created almost overnight a unified money market, which, despite the formidable transaction overload, functioned smoothly from the very start. Short interest rate volatility remained well contained, and the main refinancing operations, along with the standing facilities and the reserve requirement system with averaging provisions, have since guaranteed that money market developments remain closely in line with the ECB's intentions.

The arrival of euro banknotes and coins on 1 January this year also went very smoothly. We supplied 300 million people with a new means of payment which in sixty days replaced, without technical failures or psychological regret, currencies that had served for centuries. Exchanging the old national banknotes and coins for the new euro denominations was a massive operation requiring enormous technical effort, perfect logistical co-ordination and economic wisdom. Its success, again, exceeded the expectations of many - and perhaps even our own dreams. From the outset, the people of Europe have been enthusiastic about the euro and have quickly adopted their new money.

Key factors behind a successful monetary policy

But let me move on to my main subject today: the key institutional factors underlying the Governing Council's policy. I shall also consider the many challenges - in addition to the changeover - which we have faced since the inception of the single monetary policy.

First, the well-designed institutional framework of EMU was a key factor setting the stage for a successful monetary policy. The Treaty establishing the European Union assigned to the ECB unambiguous responsibility for the maintenance of a stable scale of value which agents can internalise in their expectations. And it has shielded monetary policy from political interference.

Price stability diminishes investment risk, reduces the cost of capital and lengthens the horizon over which lenders and borrowers wish to engage in credit arrangements. This multiplies the opportunities for agents to exercise their entrepreneurial spirits, to pursue and spread technological advances and to contribute to the well-being of society at large. Technological factors and agents' attitudes towards consumption, savings and work combine with government thrift and legislation to determine the real basis for economic well-being. Any attempts by a central bank to change this balance of real forces in the short run at the expense of the stability of the currency can only be futile and self-defeating.

Today, there is a broad consensus among economists that monetary policy is not a suitable tool for fine-tuning economic developments. Any attempts to sacrifice the medium-term goal of price stability to efforts to meet short-term objectives will ultimately weaken the stability of a currency. To prevent monetary policy itself disrupting the economy, it needs to be made and kept independent of pressures arising from short-term political and electoral objectives.

A second key factor behind a successful monetary policy is the macroeconomic policy framework laid down in the Treaty. While preserving the value of our currency is our primary occupation, the Treaty recognises that the ECB does not operate in a vacuum. So, it has created a harmonious institutional structure in which areas of shared responsibilities across policy domains are carefully avoided, and the single monetary policy finds a standing safeguard in the virtuous principles disciplining its policy counterparts. The Stability and Growth Pact is a central component in this structure. The past three decades have taught us that fiscal laxity, far from enhancing collective prosperity, has only made endeavours by central banks to preserve the value of money costly and painful. The principles underlying the Pact have restrained and ultimately reversed what appeared an unrelenting growth in public liabilities. This has reduced the long-term cost of borrowing and made easier the task of the single monetary authority.

Within the framework of the Treaty and the provisions set in place to implement the Stability and Growth Pact, national governments exchange views, agree on general guidelines and policy recommendations, and share frank assessments. For its part, the ECB accepted the invitation to participate in an informal dialogue with governments and other political actors. This was done on the clear understanding that the purpose was to share information and insights, not to receive guidance or instructions on matters of monetary policy.

The institutional balance upon which this dialogue rests, while adequate and balanced, is delicate and at times fragile. We thus take note with increasing alarm that the voices calling for co-ordinated action by the monetary and fiscal authorities have become louder and more authoritative recently. According to these voices, the 'policy mix' should be improved, and the monetary and fiscal authorities should agree on 'common standards that define general principles' guiding policy conduct over time. We note these ideas with concern. If such steps were taken, they would undermine the independence granted to the ECB in pursuing its mandate. They would alter the incentives of economic actors to discharge their respective duties to the best of their ability. They would blur policy responsibilities and instil the perception that monetary policy may have become subservient to the needs and logic of the political cycle. Not least, they would, by implication, severely damage central bank credibility, which in turn would cause painful costs, in terms of higher interest rates.

The exchange of information and advice, notably across policy domains, and more explicitly between fiscal and monetary jurisdictions, should never turn into reciprocal interference. The success of monetary policy fundamentally depends on central bank credibility. Central bank independence, a fundamental principle of modern monetary governance, should never be challenged.

A third key factor behind a successful monetary policy is the ECB's monetary policy strategy and the communication of its policy to the public. The Governing Council has clearly stated the ECB's objective and the framework used to guide its actions. The Governing Council is also very transparent about its assessment of the current economic situation and the risks to price stability involved. There are no ambiguities as to how monetary policy would respond to possible changes in the economic environment and in the balance of risks to price stability. All this provides sufficient information for other policy actors to take the steps they deem necessary. At the same time, these policy actors also know how the ECB will react to their decisions.

When setting up the ECB, a major challenge for the Governing Council was to devise a monetary policy strategy. This strategy, which was announced in 1998, is a new one, specially designed for the euro area. And compared with the strategies of other central banks, it is perhaps a more complex one. It was therefore not surprising that it has led to many discussions. In fact, the ECB has sometimes been criticised for not adopting a strategy focusing on one, or at most two indicators. Some observers claimed that the ECB, by having adopted its two-pillar strategy, might eventually downgrade the importance of the reference value for broad money growth. In their view, this would spell the danger of falling back into discretion. Other observers, meanwhile, were advocating a central - virtually all-encompassing - role for inflation forecasts.

As is now evident, we were well advised not to yield to either of these calls. It would have been unwise to base our policy on any privileged indicator or a single forecast, to the exclusion of all other pieces of information, in a changing world in which statistical inference is such an elusive guide to our real-time perception of reality. We chose to broaden, rather than narrow, our perspective of the economy. Forced to decide, we chose to err, if anything, on the side of more evidence than needed, rather than disregarding key information; we opted to be inclusive rather than exclusive.

This choice has ruled out the use of simple rules for both internal use and external communication. A central bank does not want to mislead its public with the elementary logic of a two term linear reaction formula, only to surprise them whenever circumstances demand. So observers should never succumb to the easy temptation of blaming a central bank for failing to obey a simple rule. More fundamentally: they should never lose sight of the complexity of the ‘economic story’ behind the conduct of monetary policy in a world of uncertainty.

In its interactions with the public, the ECB has never departed from an honest and faithful - if at times seemingly unwieldy - account of this complex reality. We have shared with the public the evidence reaching the Governing Council ahead of policy discussions. We have described in detail the economic rationale behind policy decisions. Those decisions are explained in the press conference after the first meeting of the Council every month, in the Monthly Bulletin, in numerous speeches by members of the Council and in my testimonies to the European Parliament. Just listening to what I say about the current state of the economy and its direction can save all that time and effort devoted to uncovering the alleged secrets of central bank thinking, or the individual views of members of the Governing Council.

Experience after four years

How did these three key factors setting the stage for a successful monetary policy have an impact on the functioning of the Governing Council and on the ECB’s monetary policy? Looking back over the past years, I can see that the mutually reinforcing viewpoints of the two pillars have served as a balanced and comprehensive basis for analysis prior to monetary policy decisions. At the same time, the complex process of cross-checking information gathered from each of the two pillars has sharpened - rather than diminished - our awareness of the changing conditions in our economic environment.

When confronted with new developments in the economic environment, the Governing Council has never hesitated to take resolute, timely action to pursue a policy stance which best serves the purpose of maintaining price stability over the medium term.

Regarding the conditions for maintaining price stability, in January 1999, the single currency was born into an environment of inflation rates hovering around 1%, below the upper limit of the range considered to be consistent with price stability. At that time, there were some signs of risks of deflation in the context of a depressed global economy and the financial distress following the Asian and Russian crises. We responded by cutting interest rates by 50 basis points in April 1999.

When, in the remainder of 1999 and in 2000, our analysis indicated that external shocks, namely the sharp rise in oil prices and the depreciation of the euro, were increasingly putting pressure on prices, and our assessment of monetary and credit aggregates signalled the existence of generous liquidity conditions in the euro area, we raised rates on seven occasions. Between November 1999 and October 2000 interest rates were increased by a total of 225 basis points in order to counteract the emergence of risks to price stability in the euro area.

In early 2001, our analysis started to signal declining inflationary pressures over the medium term. But in 2001 price developments were affected by a surge in food costs driven by an unprecedented health crisis which had disrupted important segments of the primary sector. At the same time, the lower actual and prospective economic growth was one factor supporting an outlook in which inflation rates approached levels in line with our definition of price stability. It is worth noting that the first decision to lower our policy rates was taken in May 2001, that is, when actual consumer price inflation was at its peak in the euro area. This is a clear indication of the medium-term and forward-looking orientation of our policy. Between May and November 2001, we lowered our policy rates by a total of 150 basis points.

In order to forestall imbalances that may not have been visible or evident at first sight, we have rarely been caught off guard by events. On the one occasion when we were - after the terrorist attacks in the United States on 11 September - we did not lose our nerve. We reacted without hesitation and moved swiftly to ensure that financial markets continued to function effectively.

By and large, we can claim that we have maintained a firm course of action in the day-to-day business, guided by our monetary policy strategy, and that the shocks we have experienced have received a timely and appropriate monetary policy response. Inflation has been kept under control even in the face of substantial adverse shocks.

Concluding remarks

In conclusion, I believe that all the institutional preconditions for a stable currency and macroeconomic success are in place in Europe today. The institutional construct of the Treaty has paved the way for a single monetary policy in Europe to be a lasting success. The ECB - through its strategy - has successfully implemented the framework within which it pursues its mandate. And in the daily execution of its policy, the ECB displays a firm hand and a clear sense of direction in countering inflationary risks as they emerge.

Markets seem to acknowledge this achievement. Continuous adverse price shocks have done little to shake the conviction of most Europeans that the statute and the competence of the ECB will indefinitely and effectively contain any inflationary or deflationary forces. This has constantly been reflected in well-behaved inflation expectations. Despite the fact that the recent increase in oil prices currently tends to slow down the fall in HICP inflation, long-term expectations of inflation have been remaining below 2%.

Certainly, we are less than entirely satisfied about recent price developments. Recently published inflation forecasts, developments in indicators of inflation expectations and recent trends in wages neither clearly confirm nor entirely defuse the risk of an entrenchment of upward tendencies in prices. At this juncture, it is therefore particularly important to remain vigilant with regard to the further evolution of the key factors determining future price developments. While we have to acknowledge that monetary policy cannot affect inflation developments over the short-term, we are determined not to put our achievements at risk.