Nout Wellink: Current issues in European monetary policy

Address by Dr Nout Wellink, President of the Nederlandsche Bank and President of the Bank for International Settlements, at the Euro Seminar: “A test of faith” in Tokyo, Japan, 26 November 2002.

* * *

It is always satisfying for those of us who have been closely involved in the birth of the euro to see how widespread the interest in the new currency is. Actually, the birth of a new currency is in some respects similar to the birth of a child. You can prepare for both, but you soon have to learn that you cannot fully control how it develops. Both children and currencies develop a life of their own – and you are frequently faced with unexpected challenges. Similarly, you are pleased when others take an interest in your child.

I think that I can safely say that we are now through most of the birth pains of the new currency and can now concentrate on the ‘normal’ challenges of monetary policy. My colleagues at the Bank of Japan are certainly well aware of the fact that challenges continue to develop. In that respect we have much to learn from each other.

Consistent with this observation, my comments today will not be on the immediate outlook for euro area monetary policy. Instead I will dwell on some issues that are – to a large extent – topical in discussions on central banking around the world. They include the risk of deflation, risks to financial stability, how to cope with oil price hikes, fiscal policy developments and the enlargement of the monetary union. I hope that my comments will provide insights into the way we approach these issues within the Eurosystem.

Is there a risk of deflation?

Let me begin by responding to the question of potential deflation in the euro area. A number of countries around the world are currently experiencing falling prices. In contrast, Alan Greenspan has noted that he considers that the US is not close to the deflation cliff. Before discussing the euro area situation, let me first note that persistent deflation is damaging – at least as damaging as persistent inflation, and the risks are non-linear. A small fall in prices need not be damaging, but an ongoing fall certainly is. There is no need to dwell on that here – you know that better than I do. This aversion for deflation is captured in the ECB’s definition of price stability. We define price stability as a year on year increase in consumer prices of less than 2% and seek to maintain that over the medium term. In practice, we have a preference for inflation lying within a range between around 1 and 2%. This reflects potential measurement error in price indices as well as our desire to avoid deflation.

Having flagged our aversion to persistent deflation, let me turn to the substance of the question. My answer is clear – in the present situation I see no immediate risks of deflation in the euro area, albeit for the wrong reasons. Service price inflation accounts for around 40% of the HICP index and competition in this sector is rather low. In addition, the sizeable government sector has a role in price setting in many areas. Both factors tend to put a floor under price increases. Our wage and price setting mechanisms are simply not flexible enough to allow widespread or persistent deflation in the absence of a severe or prolonged recession. Although formal wage indexation in Europe is considerably lower than in earlier decades, we are not at the point where nominal wage cuts are likely to be broadly accepted. Similarly, nominal price declines are also rather rare.

Deflationary risks generally arise from one or more of the following factors – the bursting of an asset price bubble, difficulties in the financial sector or ongoing losses by businesses. Clearly these triggers are generally interconnected, and can reinforce each other. These interdependencies make deflation such a difficult problem and its impact widespread and corrosive. Turning to a discussion of these triggers, a prolonged or severe recession is not what we are currently experiencing. In fact, we are in a situation where the relatively quick recovery we observed in early 2002 seems to have stalled. Part of the reason why we continue to feel that we are in a difficult situation is that we had hoped that the recovery would be rapid. At the beginning of this year we expected that economic growth would be close to trend by the end of this year. In fact, growth will remain substantially below potential this year and the recovery is unlikely to gain much momentum until next year. I do not want to go into the reasons behind that now. My point is simply that the current downturn is not sufficiently severe to generate deflationary pressures. And as I will argue below, the same conclusion holds as regards the other possible triggers for deflation – asset price declines or financial sector fragility.

Overall, therefore, I am confident that Europe will not experience a period of persistent deflation – and the associated problems that this could cause. I can also assure you that we are aware of the risk. In particular, we are aware that it is difficult to put the deflation genie back in the bottle once it has come out. If signs of widespread problems emerge, we will act swiftly to counter them. An advantage of our measured monetary policy response to date is that we have plenty of policy room available to react if necessary.

Is there a risk to financial stability

Closely related to the question of deflation is the issue of financial stability. A period of deflation could be caused by, or contribute to, financial stability problems as real debt burdens rise and borrowers struggle to service their debt commitments. Again, I expect that you know more about this than I do. However, let me give you my interpretation of recent developments in Europe and their implications for financial stability.

Asset price declines

One concern has been that recent stock price declines could trigger financial instability by weakening balance sheets across the economy. Clearly there has been a significant adjustment in stock prices around the world over the past year or so. Europe has also been affected. European stock prices are now back around the levels seen in 1998 and have fallen by around 30% since the beginning of this year. Nevertheless, to put this fall in perspective, stock prices remain well above 1996 levels, which was when Chairman Greenspan made his comments on irrational exuberance. This holds true even when you adjust for inflation. Regardless of whether or not stock prices are too high, a decline of the magnitude we have seen is bound to have some impact on the macroeconomy. At the Dutch central bank we have estimated that a sustained decline of 30% would have a cumulative negative impact of just over ½ % on European growth over three years. Our model implies that there will be an insignificant impact on prices. However, these estimates are for the direct influence of lower stock prices only and abstract from confidence effects.

As an aside, it is interesting to note that the wealth effects from changing share prices are considerably stronger in the United States. For example, a fall of 30% in US share prices results in a cumulative negative impact of over 3½ percent of GDP over the same three year period. There would also be a negative impact on consumer prices of a little over ½% over three years. The different impacts stem largely from the lower extent of share ownership in Europe than in the US. Although direct share ownership is gradually spreading in Europe, it remains considerably less widespread than in the United States. In addition, market capitalisation as a percentage of GDP is around 70% higher in the United States than in Europe.

House prices are the other major component of household wealth. Any widespread and significant decline in house prices would have a more substantial effect than stock price declines. This is particularly true for the euro area, where homeownership is more widespread than direct share holdings. Estimates suggest that a 30% fall in house prices would have a cumulative negative impact on GDP of over 1% in the euro area. For the US the comparable figure is over 3%, although I should note that these house price estimates are very imprecise. There are signs that the rapid house price increases some of the smaller euro area countries have experienced are coming to an end – that is certainly the case in the Netherlands. However, actual declines in house prices seem to be concentrated in only a few segments of the housing market in some euro area countries. In particular, they are concentrated in the more expensive end of the market, where there is likely to be an interdependence with the adverse demand effects stemming from capital losses in the stock market. I do not expect substantial declines in house prices to be widespread across the euro area.

Banking system concerns

The banking system in some parts of the world is being tested as a result of the current economic slowdown and the associated credit losses. Still, the European banking sector shows, broadly speaking, no sign of any widespread distress of the sort that might lead to financial stability concerns. In fact, the banking system has come through the recent decline in share prices, crises in Latin

America, and the economic slowdown, rather well. European banks generally have smaller shareholdings than Japanese banks, so their exposure to falling share prices is lower. Some consider that the German banking system is vulnerable, although I think that it remains fundamentally sound. There are signs of increasing risk aversion, as lenders distinguish more carefully between rating classes. This is showing up in wider credit spreads and in some cases in limits on lending volumes. Supervisors are alert to these trends. In the Netherlands we continue to conduct a range of stress tests to assess the vulnerability of the financial system to further shocks. We closely monitor exposure in particular markets, including in real estate, which have been a cause of problems in some countries in the past. Stress tests and monitoring have the further advantage of making the management of financial institutions more aware of the risks they face. Discussions at Basel on the new capital accord also place more attention on stress testing.

My conclusions on financial stability are therefore clear. There are no signs of financial instability in the euro area. I hope, and central banks throughout the Eurosystem are committed to ensuring, that this will remain the case. Problems that may be experienced at a few banks are not indicative of problems across the euro area as a whole. In any event, central bankers, including myself, are continuously assessing financial stability risks. I will not pretend that we will always be able to prevent instability occurring. The world and financial markets change rapidly and the lessons that we can learn from earlier experiences need to be updated. However, I do hope that we can reduce the chance of instability.

Oil prices, conflict in the Middle East and the impact on monetary policy

Let me now turn to a risk that points to higher, rather than to lower, inflation. Oil prices have been one of the most significant influences on inflation over the past three years and they remain volatile. Given the impact that even relatively moderate oil price changes can have on inflation, this volatility poses an ongoing challenge for monetary policymakers. The possible consequences of any conflict in the Middle East only increase the uncertainty as we look ahead.

Oil prices currently incorporate a risk premium, to an unknown extent, regarding a possible Middle East conflict. Therefore, the additional impact on prices from a conflict is unknown. It is also possible that oil prices could decline within a short period of time. Any conflict might also result in an exchange rate reaction, although the direction and size of this is unknown. It is possible to develop plausible arguments both for and against a strengthening of the US dollar.

Given these uncertainties, I am not going to try to forecast the exchange rate. If I could do that with any degree of accuracy, I would probably be sitting on your side of the room as an analyst or trader, rather than standing here as a central banker. Whichever way the exchange rate moves, its impact could be critical in determining monetary policy reactions – not only in Europe, but also in other countries. Policy makers with appreciating currencies will have less need to tighten policy – or more room to ease – than those confronted by depreciating currencies.

So, instead of trying to achieve the impossible task of describing the precise policy response to any conflict, I will say something briefly about the framework we use in assessing the issue. An obvious but sometimes overlooked point is that ECB monetary policy is based on an comprehensive assessment of the outlook for price stability. This is affected, but not solely determined, by movements in oil prices. To the extent that oil prices do alter the outlook for price stability, we try to look through the so-called first round impact, but try to counter any second-round impact. In the oil crises of the 1970s, we learned that we need to prevent an upward wage-price spiral developing. Luckily this is nowadays easier to achieve for two reasons. Firstly, there is less wage indexation so such a spiral is slower to develop. Having inflation expectations anchored at low levels also helps. The second key factor is that our dependence on oil is now lower.

Fiscal policy developments and the Stability and Growth Pact

Let me now turn from issues closely connected to monetary policy decisions, to two that form part of the environment within which we operate. The first is fiscal policy. While all central bankers sometimes face challenges from fiscal policy makers, I think that those in the euro area are rather unique – and stem from the fact that we are a monetary union of sovereign states. Within Europe there is clarity and consensus about the institutional framework covering the relationship between fiscal and monetary policy. Despite this consensus, discussions continue about the detailed implementation of the framework.

As you know, a number of countries have made insufficient progress towards fiscal consolidation in recent years. Some countries are not going to reach a balanced-budget position by 2004, as intended. More seriously, several have, or are likely to, post deficits exceeding 3% of GDP. The lacklustre economic climate obviously plays a part in explaining this fiscal slippage. Equally obviously, several countries failed to make sufficient consolidation efforts during the earlier period of robust economic growth. Instead, they took advantage of the growth years to lower taxes and raise spending in the mistaken belief that the good years would never end. Sadly, one of life's lessons is that all good things eventually come to an end. Countries that did not follow the rules are now suffering the consequences.

Again, the analogy with children comes to mind. As any parent knows, children need clear rules – and these rules need to be enforced. Both parents and monetary policy makers understand the need to be consistent if credibility is to be maintained. We've learned that the hard way. The same rules of life apply to fiscal policy. Credibility suffers if you do not do what you promised to do. Moreover, if these rules are not adhered to, problems could also develop in other areas of common European policy. Enforcement mechanisms will lack credibility.

In a sense, it is this risk of the loss of credibility that is most concerning about current developments in euro area fiscal policy. Everyone agrees that there can be no return to the large fiscal deficits of the 1970s. That simply crowded out private sector investment. The importance of reaching a sound fiscal position is reinforced by the need to plan ahead for the fiscal consequences of population ageing. Postponing the adjustment will not make it any easier – and nor will the problem disappear. Had countries undertaken the necessary fiscal consolidation in the good years and reached a position of fiscal balance, the 3% deficit limit imposed by the Treaty would have been sufficient to deal with the slowdown. However, we should keep the current events in perspective. The budget deficit for the euro area as a whole is expected to just over 2% of GDP in 2002 and 2003. By way of comparison, the US deficit is expected to be over 3% in both years.

Enlargement of the European Union and the European Monetary Union

The last issue that I want to discuss today concerns European enlargement. As you know, up to 10 countries are likely to join the European Union in 2004. Two years later, at the earliest, these countries could be eligible to join the monetary union and to participate in the decision making processes within the ECB.

Some commentators have argued that enlargement could prove damaging for the expanded monetary union. Two main arguments seem to be given. The first is that decision making will prove impossible within such a large group. The second is that if economic conditions in accession countries are different from those in the rest of the euro area, and their governors vote on the basis of national economic circumstances rather than euro area developments, monetary policy settings will be incorrect.

Let me first cover the discussion about the number of decision makers. In comparison with other central banks, the current size of the ECB's Governing Council is large. We have 18 members. That has not been a problem in taking interest rate decisions to date. In fact, my experience is that we are able to efficiently discuss the key issues and reach our decisions. Nevertheless, we cannot continue to expand the Council without limit.

However, the problem is, in my view, largely one of perception. There are concerns that we will be unable to take decisions efficiently and that enlargement may lead to a focus on national developments, rather than on the euro area as a whole. To address these concerns, a rotation model might be introduced that would restrict the number of national central bank governors with a vote at any point in time. The United States Federal Reserve uses a form of rotation for their Federal Open Market Committee. However, let me stress that I do not expect the substance of our discussions or decisions to change. The fact that we will all continue to participate in discussions, even if we have no vote, will facilitate this continuity. Our focus will continue to be on the euro area as a whole.

Conclusions

Looking at the key issues currently facing us at the ECB, it seems to me that our new currency has rapidly ‘grown up’. Our challenges are no longer those uniquely associated with the birth of the euro. Instead, we are mostly concerned with issues that are challenges for central banks around the world. That doesn’t make our job easier, but does at least mean that we are moving out of uncharted territory.

Of course, financial market analysts and the media have also had to get used to the issues we are confronted with, and our style of dealing with those issues. I think that our coming of age as a currency is also reflected in the comments we now attract from analysts and the media. There seems to be increasing understanding about what we are trying to do and how we go about it. There is, naturally, always room for improvement. I hope that my comments today have made a contribution in this respect by adding to your understanding of how we go about monetary policy formulation within Europe.