Jean-Claude Trichet: The ECB's monetary policy strategy after the evaluation and clarification of May 2003

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, delivered at the Center for Financial Studies' key event, Frankfurt am Main, 20 November 2003.

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It is a pleasure to address such a distinguished audience. I am particularly happy to be able to devote one of my first public speeches as President of the ECB to a topic of fundamental importance for the ECB: its monetary policy strategy. As you know, this is a topic which the Governing Council of the ECB discussed at great length in the first half of 2003, when we conducted an evaluation of our experience with the strategy. This review resulted in the confirmation of our strategy on 8 May 2003. On the same day we also introduced some clarifications which have already proved very useful, particularly in terms of presenting and communicating to the public the more complex aspects of our monetary policy strategy.

My aim here today is not so much to explain the meaning and details of the recent clarification, but rather to provide you with a description of the main features of the strategy. I will also address some important differences between our concept and alternative strategies, and I will explain why I consider the ECB's strategy to be perfectly suited to the monetary policy of the euro area. I will then say a few words about the importance of sound public finances and structural reforms, particularly at such a critical point in time.

1. The ECB's monetary policy strategy in a historic perspective

In the initial stages of Economic and Monetary Union (EMU) in the early 1990s, many observers doubted that the single currency would ever see the light of day. Then, when they realised that it would come, they speculated that only a few countries would be able to join.

Once it became clear that most EU countries were in a position to adopt the euro, some experts argued that the quality of the euro as a new currency would converge only towards a sort of an arithmetic average of the legacy currencies, rather than to the benchmark set by the stronger ones.

It is now clear that such bouts of scepticism were much overdone. Yet it was understandable that a substantial number of observers were initially cautious with regard to the euro's chances of success. After all, monetary integration in Europe was in itself an extraordinary innovation, which was surrounded by a large number of uncertainties in the introductory phase.

On the achievements of the Eurosystem to date

But the facts have disproved those initial fears and have shown that most people underestimated the resolve of European governments and central bankers to make EMU a large-scale success as well as a huge step forward in Europe's history.

For nearly five years now we have had a single monetary policy conducted by the Eurosystem. Ever since the start of Stage Three of EMU, the Governing Council of the ECB has had to confront important challenges. We have witnessed two euro changeovers: the introduction of the euro first in book-entry form and, second, in the form of banknotes and coins. These were not simple tasks. But they both went very smoothly, thanks to the hard work of all those involved at the ECB and the national central banks (NCBs), as well as in the private sector. Monetary policy has had to face a number of shocks to the euro area economy over the past few years. For a large part of this time, policy had to be conducted in a context of exceptional economic, financial and even geopolitical uncertainty. But we kept a steady hand and did not overreact. Consequently, in spite of often difficult circumstances, we kept inflation and inflation expectations low. And we have done so with pragmatism and determination. Even in its infancy, the ECB showed itself to be a mature central bank.

These outstanding achievements underpin the rapid build-up of credibility in the ECB and the high level of confidence enjoyed by the new currency.

The Governing Council of the ECB presented its monetary policy strategy in October 1998. The design of the strategy had to be geared towards the special characteristics of the euro area economy. It incorporated, in an integrated framework, many features of the successful monetary policies of the National Central Banks of the countries adopting the euro. The strategy lays out the principles that guide monetary policy decisions. Announcing the strategy has permitted the ECB to make clear its commitment to the price stability objective. The strategy has also provided a framework in which to organise and present to the public the information used in policy deliberations.

The 2003 review of the strategy: confirmation and clarification

In December 2002 the ECB announced its decision to conduct a comprehensive review of its strategy. This decision was sometimes wrongly interpreted by observers as an implicit indication of dissatisfaction with the experience thus far. In fact, the opposite was true. It was natural that, after more than four years of experience, the Governing Council of the ECB wanted to look back and reflect in a systematic way on the experience gained and the comments of external observers. Indeed, we conduct monetary policy in a complex and changing environment. Undertaking such an exercise in stock taking and reflection is essential to ensure a satisfactory evaluation of the strategy. As I will explain, the result of this evaluation demonstrates that our monetary policy is based on a sound, robust fundament.

[The document entitled “Overview of the background studies for the reflections on the ECB’s monetary policy strategy” (8 May 2003) provides a detailed discussion of the issues considered in the Governing Council’s review of the strategy. It is available on the ECB’s website in the section Publications.]

2. The elements of the ECB’s strategy

2.1 The objective of price stability

The basis for the strategy is the **ECB’s mandate that the primary objective of monetary policy should be to maintain price stability**. This mandate, which mirrors the mandates of a very large majority of the EU National Central Banks before 1998, is enshrined in the Maastricht Treaty, which was signed by all governments of the European Union and ratified by all the parliaments. It is “written in stone”, if you wish.

It reflects the well established fact that price stability is a prerequisite for sustainable growth and the creation of employment. Price stability preserves and bolsters consumers’ purchasing power, thus supporting consumption. It also enhances the efficacy of the market system in allocating resources. Price stability is associated in particular with lower uncertainty and risk premia in financial markets, facilitating financial transactions and ultimately implying lower medium and long-term interest rates. This fosters investment. Lasting price stability is also an indispensable nominal anchor for wage developments in line with productivity thereby contributing to preserve the competitiveness of the euro area economy.

The evidence provided by experts and academics confirms and even strengthens the conclusion that departures from price stability entail substantial distortions and welfare costs, which manifest themselves thorough various channels. In short, maintaining price stability is the contribution of monetary policy to sustainable growth, job creation and social cohesion. Price stability is a necessary condition to attain those goals.

2.2 The ECB’s definition of price stability

To make the Treaty mandate operational, the Governing Council of the ECB has provided a **quantitative definition of price stability**. Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area as a whole of below 2%. By referring to increases in the HICP it was made clear from the beginning, in 1998, that deflation is excluded from the definition of price stability. The Governing Council also specified that price stability is to be maintained over the medium term.

In the light of past experience, it is clear that the announcement of the quantitative definition of price stability was an extremely valuable element of the ECB’s strategy.

First, the ECB’s definition of price stability has been instrumental in enhancing the transparency of the policy framework and thereby the accountability of the ECB.

The anchoring of long-term inflation expectations

Second, with its quantitative definition the ECB has made a very significant contribution to the firm anchoring of inflation expectations. The definition of price stability permits all economic agents and the public at large to build expectations of future inflation outcomes. By providing a benchmark for inflation expectations, the quantitative definition of price stability has considerably facilitated the conduct of monetary policy by the ECB. Indeed, if the public can trust the ECB, we can assume that the setting of wages and prices will be compatible with the ECB's definition. This significantly reduces the likelihood of temporary bouts of inflation triggering harmful wage and price spirals, as was the case in previous decades.

In our evaluation of the strategy we analysed particularly closely the experience with euro area inflation expectations. We were very pleased to see that the volatility of **long-term inflation expectations** in the euro area is as low as in the best performing industrialised countries in this respect. Since January 1999, medium and long-term inflation expectations, as measured by survey data, have remained stable most of the time within the range of 1.7 to 1.9%, thus at a level compatible with the definition of price stability.

This is all the more remarkable given that the ECB started without a track record of its own and was faced with a number of sizeable, mainly upward, price shocks hitting the euro area economy. In mid-2000 the price of the Brent oil barrel denominated in U.S. dollar was four times higher than at the start of the single monetary policy, in January 1999. Since then, average oil prices have stayed at a considerably higher level than the average over the previous ten years. In 2001, when the indirect effects of the earlier oil price increases were still exerting upward pressure on the HICP, some EU countries were affected by livestock diseases. This caused exceptionally strong upward pressure on unprocessed and, later, processed food prices. As a result of these shocks, HICP inflation has for quite some time been above, and sometimes significantly above, the 2% mark. But, as I just said, medium and long-term inflation expectations remained rather stable despite those shocks. As the shocks gradually unwound, actual inflation rates always bounced back toward levels compatible with price stability.

In our reflections on the strategy, we discussed at length all the aspects related to the ECB's definition of price stability. We scrutinised again the properties of the price index, the HICP. We assessed the merits of the possible alternatives for expressing the price stability objective, that is, whether to express it in terms of a single "point" or a "range". We also reviewed the factors determining the "optimal" rate of inflation, to assess the adequacy of the 2% upper limit in the definition and the appropriate aim of monetary policy. In this assessment we concluded that, on the grounds of both conceptual considerations and practical experience, the ECB's definition is fully adequate.

The May 2003 clarification: "HICP inflation below but close to 2%"

At the same time, we felt the need to convey even more clearly to the public that the Governing Council is not indifferent between all positive inflation rates below 2%. On 8 May 2003 we made it clear that, in order to fulfil its price stability objective, the Governing Council aims to maintain HICP inflation below but close to 2% over the medium term. This was fully in line with our past practice and with medium-term market expectations. Thus, the announcement did not change inflation expectations. We identified a number of arguments for aiming not at inflation close to zero but at a rate close to 2%.

Rationales for aiming for positive inflation (1): the zero lower bound for nominal interest rates

The first argument is that maintaining a low positive rate of inflation **reduces to very low levels the probability that nominal interest rates will approach their lower bound at zero**. The event of nominal interest rates hitting the zero lower bound is linked to an increased uncertainty about the effectiveness of monetary policy. If this event were to coincide with a strong decline in demand, such a situation could complicate the central bank's ability to avoid a deflationary episode. Examples where countries reached the lower bound for nominal interest rates are rare. And even if this event were to materialise, a number of effective monetary policy actions are still possible at zero nominal interest rates and various plausible solutions for escaping from a liquidity trap have been proposed. This notwithstanding, prevention is better than cure and a safety margin for inflation rates above zero proves helpful to avoid that the effectiveness of these alternative policies has to be tested in reality.

In order to calibrate the adequate safety margin for inflation rates in this respect, we took into account the studies which have tried to assess the likelihood of nominal interest rates hitting the zero lower bound for various levels of inflation objectives. Results in this area differ to some extent, as they depend on a number of specific assumptions. But the available studies indicate that the likelihood decreases to very low levels when the central bank aims at an inflation rate above 1%. We are thus convinced that focusing on inflation of below but close to 2% provides a sufficient safety margin against nominal interest rates hitting the zero lower bound.

Rationales for aiming for positive inflation (2): measurement error in the HICP

A second reason to aim for low positive inflation is that available inflation statistics may be subject to a **positive measurement error**, which would imply that strict price stability, that is, zero inflation, as measured by the price index would de facto mean a declining price level. In the specific case of the HICP, the precise estimation of such a measurement bias continues to be surrounded by uncertainty. But taking into account the continuous improvements implemented by Eurostat in the index, the bias is likely to be small and to decline further in the future.

Rationales for aiming for positive inflation (3): inflation differentials within the euro area

Third, as regards the possible presence of **sustained inflation differentials within a currency union**, I should note that such differentials are and should be considered a normal feature of any currency area. Indeed, they are an integral part of the adjustment mechanism resulting from not fully synchronised economic shocks in the various countries forming the euro area. The single monetary policy cannot address such differentials, in the same way that in a single country monetary policy cannot reduce inflation differentials across regions or cities. Depending on the causes of temporary differentials, national remedies may be needed to prevent harmful developments in the country, notably in connection with competitiveness. Overall, it is crucial that product and labour markets in the euro area are sufficiently flexible to respond efficiently to supply and demand shocks. This assessment was confirmed in a recent and comprehensive study by the Eurosystem's staff on inflation differentials in the euro area. ["Inflation differentials in the euro area: potential causes and policy implications", European Central Bank, September 2003, Publications.] This study noted, interestingly, that the size of the inflation differentials within the euro area is broadly comparable to that in the United States, although in the United States inflation differentials show somewhat lower persistence over time. This study highlights the inadequacy of using monetary policy to address such differentials, which primarily reflect transitory effects of monetary integration in Europe and also relate to the persistent differences in economic structures across countries.

Among the possible structural factors underlying lasting inflation differences, the **Balassa-Samuelson effect** has been often singled out. The Balassa-Samuelson effect relates inflation differentials to differences across economies in the relative sectoral productivity trends between the tradable and non-tradable sectors. Empirical studies indicate that the magnitude of the Balassa-Samuelson effect is very limited in the group of countries forming the euro area. Furthermore, the size of the Balassa-Samuelson effect for these countries is diminishing over time, given that there has been substantial convergence among countries in terms of per-capita GDP and productivity levels. The size of the Balassa-Samuelson effect could well be more important for the acceding countries. However, its overall impact on the euro area should be limited, not least on account of the relatively small size of these economies. Moreover, it should be recalled that, in order to adopt the euro, the acceding countries will have to fulfil the Treaty convergence criteria, which in particular require the sustainability of a low inflation environment. All this points to a more limited impact of the Balassa-Samuelson effect than is sometimes claimed.

In sum, aiming for inflation rates below but close to 2% offers an additional safeguard against the rather remote but undesirable event that nominal interest rates could hit their lower bound at zero. At the same time, it is also fully sufficient to cover the possible presence of a measurement bias in the HICP and the implications of inflation differentials of a structural nature within the euro area.

The format of the price stability objective

As regards the **form in which our inflation objective is expressed**, I am aware that here in Germany some observers recently called for the ECB to adopt a specific "point target" for inflation. As I mentioned before, this option was considered carefully by the Governing Council. However, after examining thoroughly all the arguments and available evidence in our review of the strategy, the Governing Council deemed it preferable to avoid this option and to announce that we aim at HICP inflation below but close to the upper bound of the range in the definition.

With our decision we convey to the public the important message that the control of inflation is inherently imperfect.

As regards the theoretical advantages of referring to a specific rate of inflation as the objective, it has sometimes been argued that, in principle, it provides a more precise focal point for forming inflation expectations and taking forward-looking decisions. We therefore looked at the evidence on the experiences in various countries in this respect. We concluded that, above all, there is no unique or best way to firmly anchor inflation expectations. The crucial aspect appears to be a credible and consistent conduct of monetary policy. In this respect the ECB has been very successful - as is demonstrated by surveys and the "jury" which is bond markets.

The medium-term orientation of monetary policy

Another very important aspect of our monetary policy, which was also emphasised at the start of Stage Three of EMU, is that it aims to maintain price stability over the medium term. The **medium-term orientation** clarifies that there is no fixed time horizon over which price stability has to be re-established. The medium-term orientation embodies several important general principles of the strategy. First, the explicit acknowledgement that, given the long and uncertain lags in the transmission of monetary impulses, central banks cannot steer short-term price developments with high precision. Second, it also reflects the idea that monetary policy should react differently to different forms of economic shocks. Notably, supply-side shocks, for example those to oil prices, often require a much more gradual monetary policy response than shocks on the demand side of the economy or shocks coming from labour cost developments. By adapting the appropriate monetary policy horizon to the nature of the shock, the ECB helps to avoid unnecessary volatility in output growth.

In sum, the focus on the medium term in the ECB's monetary policy strategy embodies a commitment to avoid overly activist and ambitious attempts to fine-tune inflation outcomes, while reinforcing the credible anchoring of our definition of price stability in the medium and long-term expectations of economic agents and markets.

2.3 The two pillars

A further element of the strategy relates to the analyses and economic perspectives of the risks to price stability, which are founded on a **two-pillar framework**. The two-pillar approach permits conveying to the public the notion of a diversified analysis and of ensuring robust decision-making based on different analytical perspectives.

These two perspectives are referred to as "economic analysis" and "monetary analysis". The Governing Council has emphasised the lively and dynamic nature of the analyses under the two pillars of the strategy: over time, the analyses under both pillars have been deepened and extended, in line with increasing data availability and continuous improvements in technical tools. Obviously, this process of improvement of the analysis will continue in the future.

Economic analysis

The **economic analysis** focuses mainly on the assessment of current economic and financial developments, their likely future dynamics, and any implied short to medium-term risks to price stability.

To fully assess the economic situation and the outlook for price stability, the Governing Council must be able to call on a variety of tools and models. However, judgement is also needed, particularly in assessing the likelihood of certain hypothetical scenarios eventually materialising. The Eurosystem staff macroeconomic projections constitute one important input into the monetary policy decision as a way of organising a large amount of information and helping to create a consistent picture of possible future developments. However, they cannot be made the sole tool for the conduct of monetary policy: economic forecasts never encompass all the relevant information, and they can never be a substitute for the judgement that is needed on the part of the policy-maker.

A further important aspect of economic analysis is a thorough assessment of economic shocks and dynamics. In addition, expectations held by the private sector of future inflation and activity as well as economic forecasts provided by international organisations are analysed regularly.

Monetary analysis

As regards the **analysis under the monetary pillar**, the ECB decided from the outset to single out money from the set of selected key indicators that it would monitor and study closely. To mark the fact that, in the medium and long run, inflation is indeed a monetary phenomenon, the Governing Council announced a reference value for the growth of a broad monetary aggregate.

These decisions were made in recognition of the fact that monetary growth and inflation are closely related in the medium to long run. Indeed, assigning money an important role underpins the medium and long-term orientation of the strategy. It helps policy-makers to see beyond the more transient impact of the various shocks affecting the economy and to implement the adequate gradual course for the conduct of monetary policy.

To underline the medium to long-term orientation of the analyses under its monetary pillar, the ECB has always emphasised the fact that there would be no strict link between short-term monetary developments and monetary policy decisions. Monetary policy would not, therefore, react mechanically to deviations of M3 growth from the reference value. Rather, the reference value performs an important role as a medium to long-term quantitative benchmark for assessing monetary developments. It constantly reminds the central bank of the fundamental principle that, while responding to economic developments, it must never lose sight of the fact that, over sufficiently extended horizons, the rate of money growth must be consistent with the price stability objective.

The ECB knew from the beginning that it is difficult in practice to extract information on price trends from the short-term movements in money. Developments in M3, which is our key monetary aggregate, can always be affected by smaller or larger shocks which are not necessarily related to inflation. In this respect, the period since 2000 has been exceptional. We have seen an unprecedentedly long period of stock market declines. This persistent weakness in global stock markets drove investors away from equity and induced a reallocation of portfolios of euro area non-MFI investors towards low-risk assets. As a consequence, for a rather long period of time, M3 growth has been distorted upwards without this necessarily signalling inflation risks. However, we thus far have little reason to assume that we have a breakdown in the long-term stability of money demand.

The May 2003 clarification: the role of money in the strategy

In its recent review of the strategy, the Governing Council of the ECB further emphasised the medium-term orientation of its monetary analyses and clarified the role of monetary analysis in the strategy.

On 8 May 2003, the Governing Council decided to discontinue its earlier practice of reviewing the reference value for M3 on an annual basis. In the past, at the end of each year, the Governing Council had reviewed the assumptions about the medium-term trends in potential output growth and the income velocity of M3 underlying the derivation of the reference value for M3. The decision to discontinue the regular annual review is more in line with the medium and long-term nature of the assumptions underlying the computation of the reference value. It may also help to dispel occasional misperceptions in the public that the former practice implied a reference value that was specifically applicable - like a monetary target - to the year ahead. The Governing Council will, however, continue to monitor the validity of the conditions and assumptions underlying the reference value and communicate any changes to the underlying assumptions as soon as they become necessary.

On 8 May 2003 the Governing Council also clarified the way in which it integrates the indications stemming from these two complementary analyses as it seeks to come to an **overall judgement on the risks to price stability**. In particular, it emphasised that the monetary analysis mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications coming from the economic analysis.

2.4 The ECB's strategy and inflation-targeting strategies

The two-pillar framework, in conjunction with the medium-term orientation of the ECB's monetary policy conduct, has over time become the hallmark of the ECB's strategy. These features, among others, distinguish the ECB's strategy somewhat from the approaches implemented by some other central banks, in particular from **inflation-targeting strategies**. The notion of inflation targeting has changed over time and it is not a clearly defined concept. It is nevertheless true that the ECB's monetary policy concept and the "inflation targeting" concept are relatively close in some respects: in particular the quantitative setting of the inflation target in the latter is close, without being identical, to the quantitative definition of price stability in the ECB's concept. In both cases there is a level of transparency and of accountability unequalled by other monetary policies. However, inflation targeting is sometimes seen as a framework that makes macroeconomic forecasts the main, or even the sole, all-encompassing tool of the policy-making process and of the external communication of policy decisions. In fact, in some, admittedly more extreme characterisations, inflation targeting is seen to imply a simple policy rule whereby changes in interest rates should feed back from the deviation between a conditional inflation forecast and the inflation objective at a specific fixed time horizon, typically around two years.

I have already explained why it is our conviction that limiting attention to an ex ante fixed horizon would be arbitrary and could induce sometimes short-sighted, sometimes delayed reactions. I should mention the recent tendency seen in some inflation-targeting central banks towards relaxing their emphasis on a *fixed* horizon, in favour of the more flexible medium-term notion. In this respect, we may see those central banks as moving closer to the approach adopted by the ECB.

Our monetary policy framework acknowledges the need to flexibly take into account the nature of shocks hitting the economy and the prevailing economic circumstances. Monetary policy needs to focus on the period covering the whole transmission process, bearing in mind that this may sometimes span a protracted period of time.

This flexibility, together with the special emphasis on a medium to long-term perspective for economic developments, imparts a fundamental robustness to the ECB’s policy. As I mentioned already, the longer-term perspective of our policy is also underpinned by the emphasis on medium to long-term monetary analysis.

As an important side effect, the regular examination of monetary trends might help to detect financial imbalances. There is often a strong positive correlation between credit growth and rapid rises in asset prices in the run-up to a speculative bubble. The emergence of such long-run disequilibria in the economy has to be taken into account in setting monetary policy. Such fundamental imbalances may cause problems for the economy well beyond typical inflation forecast horizons. I note that this point of view is increasingly also considered by other central banks. Our framework, with its emphasis on monitoring money and credit developments and the sustainability of macroeconomic developments, is in this respect well equipped to take into account the implications of exceptionally strong dynamics in the financial markets in terms of potential risks to price stability over the long run.

Limitations of economic forecasts

As regards the role of forecasts and projections, it is our view that an exclusive focus on an **inflation forecast** would neither do justice to the intrinsic complexity of the decision-making process, nor would it provide a transparent means of communicating this complexity. An articulated analysis of the economic forces at work in the economy is always preferable to the use of a single summary indicator.

In practice, inflation forecasts and projections, but also other model-based exercises, are often subject to a number of well-known limitations, notably as regards the problem of model misspecification. The possible presence of **model misspecification** is something that economists and econometricians sometimes have difficulty in acknowledging. However, we are very well aware that every model we develop contains shortcuts and approximations. This uncertainty is exacerbated by the fact that economists do not agree upon a proper, commonly accepted approximating model. This implies that the appropriateness of a monetary policy strategy cannot be evaluated by means of just one particular model or class of models. Rather, a good candidate strategy needs to perform well across a variety of empirically plausible models, and it has to allow for the judgement of policy-making bodies.

There is no doubt that inflation forecasts, while being useful, even indispensable ingredients of monetary policy strategy, cannot be the only input into monetary policy-making. The same inflation forecast figures can be associated with quite different states of the world, commanding quite different reactions on the part of the central bank. For this reason too, the appropriate monetary policy for maintaining price stability should always be made conditional on the circumstances and the nature and magnitude of the threat to price stability. For example, it would depend on whether a shock is temporary or permanent, on whether it has emerged on the supply or the demand side, or on whether it is of domestic or external origin.

2.5 Conclusions on the strategy: continuity with the past and in the future

Let me conclude my remarks on the ECB's monetary policy strategy by pointing out that the ECB's Governing Council thinks that it has a sound and robust concept for the monetary policy strategy of the euro area. The fact is that this strategy has performed its task well from the outset. Let me highlight five points here.

First, the ECB implements a clear monetary policy concept. The ECB is unambiguously bound to its price stability objective and price stability is clearly defined. The strategy makes it clear that the ECB maintains a firm and steady hand to respond to disturbances in price stability.

Second, the ECB's policy reflects realism and pragmatism. The ECB recognises that the laws of motion of the economy are not easily reduced to a system of equations. Instead, the ECB's strategy emphasises the broad principles that guide monetary policy. This flexibility helps to avoid some of the limitations and risks associated with more narrowly defined monetary policy strategies.

Third, the ECB's monetary policy is built on the principle of robustness. At the core of the strategy are fundamental and successfully tested results of monetary theory, which are robust across empirical analysis and theoretical models. The ECB's monetary policy places particular emphasis on the need to take all relevant information and models into account when formulating policy decisions.

Fourth, our framework enhances the transparency and accountability of the ECB. The framework helps to convey to the public the complexity surrounding the monetary policy process, providing an honest account of all the relevant factors considered in monetary policy deliberations. Such transparency has enhanced the effectiveness of external communication, thus fostering the process of transmission of monetary policy decisions to the economy. At the same time, the use of the same framework for external communication as for internal analysis has guaranteed consistency and improved public understanding of how monetary policy is conducted. Empirical studies show that the ECB has been, in the eyes of the market, at least as, if not even more predictable in its monetary policy decisions as most other central banks in the industrialised world.

Fifth, the framework provided by the strategy has facilitated the debate within the ECB's decision-making bodies. In the decades preceding Stage Three of EMU, the NCBs forming the Eurosystem accumulated a wealth of mutually consistent yet diverse experiences and views. The ECB's strategy has provided a commonly accepted framework within which these various experiences and views contribute to policy decisions.

I can assure you that we will build on this continuity with our previous experience also in the future. Indeed, our experience so far with the stability-oriented monetary policy strategy and the results of the recent evaluation give us the confidence to continue to implement our strategy with the same vigour and determination as in the past.

3. Europe's present challenges: elevating the growth potential through structural reforms and enhancing confidence in the fiscal strategy

I have reviewed the main achievements of the ECB so far: notably, the implementation of a sound monetary policy concept; the rapid build-up of credibility in the ECB; the fact that inflation and inflation expectations in the euro area have remained in line with our definition of price stability, in spite of the clustering of sizeable upward price shocks in 2000 and 2001; and, not least, the fact that we have successfully averted creeping fears of deflation amid global concerns regarding rapid declines in inflation or even deflation in some major markets.

But I can assure you that we are not complacent about our past achievements. We recognise that new and important challenges are constantly emerging, and we are aware that credibility and confidence are assets that central banks can develop only gradually but that can be lost rapidly if the central banks are not vigilant at all times.

Elevating the growth potential through structural reforms

More than ever there is in Europe a need to push ahead with **structural reforms** for enhancing the competitiveness of the euro area. Structural reforms in the labour and product markets, and in social security systems, are needed to allow a more flexible allocation and utilisation of capital and human resources, thereby enhancing the euro area's growth potential and facilitating the adjustment to economic shocks. The Governing Council very strongly supports recent and ongoing efforts by a number of governments in this direction and also encourages social partners to fully commit themselves to the objective of making the euro area a more dynamic and innovative economy as called for by the "Lisbon agenda", which was agreed upon by the European Council in 2000.

At our press conference on 6 November I mentioned that one challenge for the Eurosystem would be to explain why structural reforms would enhance Europe's growth potential. Such changes are always difficult to implement, as the benefits are not immediately clear to many citizens. Explaining to the general public the reasons for and advantages of structural reforms is something we trust is important.

What the euro area economy really needs is a **higher long-term sustainable growth rate**.

Such a higher growth potential can be brought about via various channels: by enhancing productivity growth, by introducing measures that facilitate employment creation and by providing incentives for higher labour force participation and longer working hours for those who want them. I am convinced of the need to rely on all these channels. Such reforms should be designed to give a clear signal for job creation. We need convincing assurance that in the near future, as well as over the longer term, labour and product market rigidities will be *substantially* lower than what is currently the case. This is a crucial element for enhancing the confidence of workers and entrepreneurs, of consumers and of domestic as well as international investors.

Sound supply-side policies should aim to increase the flexibility of the labour markets, reducing the disincentives to work. Such policies would enhance confidence that working hard and undertaking new investments in human and physical capital will not be penalised through costly rigidities. Entrepreneurs and international investors would invest more in equipment and research in the euro area and offer new jobs. Such a reform agenda would enhance supply-side dynamics and thus potential output growth in many ways.

Many euro area countries are currently at a crossroad. If they pursue and fully implement these reforms, they have a good chance of prospering and maintaining the core features of solidarity and public welfare. That is why we firmly support governments and social partners that courageously embark on those reforms. Failure to implement them would not only imply fewer new jobs and lower real income, but would also seriously call into question the sustainability of social security systems. It would, in the future, require much deeper cuts in the level of welfare than what is currently required. As a last resort, the reforms are particularly necessary for those who are unemployed and those who are most dependent on government support and who fully deserve our solidarity.

If governments and social partners deliver those necessary reforms, I believe that we will not have to wait many years to see the first positive results. Indeed, impetus from structural reforms would set in motion a virtuous circle of increasing confidence and success in the reform process: the more credible the reforms are, the more confidence they will create, and the more confidence is created, the quicker we will see the positive results.

The upswing which we currently foresee is a first sign that confidence is returning, and that some governments have seriously started to discuss structural reforms. It is essential that the reforms currently being discussed are carried out, otherwise disappointment will be great and employment creation will suffer.

Enhancing confidence in fiscal policies through compliance with the Stability and Growth Pact

Growth and job creation depend not only on monetary stability and structural reforms but also on the **improved confidence** of the various constituencies of economic agents. And confidence depends very much on the soundness of fiscal policies. This is why we encourage all governments concerned to display their willingness to abide by the rules of the Stability and Growth Pact. By doing so, they will reduce public spending, which is conducive to growth through the alleviation of unproductive spending and reduction of costs in the economy. By doing so, they will credibly reduce public finance deficits, which is conducive to growth by helping diminish medium and long-term market interest rates. By doing so, they will improve the confidence of the household and business constituencies, notably by guaranteeing that taxation will not increase in future years and therefore they will foster growth through more dynamic consumption and investment.

In this respect it is clear that there is a very close relationship between the structural reforms already mentioned and sound fiscal policies. Structural reforms in state and local authorities' spending and in social security management are vital to create room for manoeuvre, facilitating the reduction of deficits and - if there is enough room to permit it - the reduction of taxes.

Positive spillover effects from structural policies for the conduct of monetary policy

You may ask what all this has to do with monetary policy. First, as the central bank responsible for the euro area, we place great value on seeing a major necessary condition for growth, job creation and prosperity for current and future generations being fulfilled: ensuring price stability, confidence in the euro and its purchasing power is our own decisive contribution to sustainable growth. And this contribution is less difficult to deliver in an environment where governments and social partners contribute to confidence and potential output growth.

I would also like to emphasise the **strong complementarities of carrying out sound policies in the different fields**. Policies that contribute to lower current and future taxes, moderate labour cost increases and higher productivity in the euro area could allow monetary policy to maintain price stability by keeping rates relatively low as long as aggregate demand lags behind supply-side dynamics. By contrast, non-disciplined fiscal policies, wage increases in excess of productivity growth and higher taxes would undermine confidence and thus reduce potential output and longer-term growth. Such a situation could soon lead to unwelcome inflationary pressures if not counteracted by monetary policy.

4. Overall conclusions

EMU is based on the conviction that Europe can derive strong benefits from a "culture of stability and confidence" in which there is a clear allocation of responsibilities to different policy-makers. Monetary policy has made its contribution to achieving this aim. Price stability is ensured and inflation expectations have been well anchored in the medium and long-run. Thanks to the high level of confidence in the euro we have a financial environment all over the euro area which is favourable to growth and job creation.

In the field of fiscal policies the arguments in favour of the Stability and Growth Pact are not simply based on fiscal orthodoxy for the sake of orthodoxy. They are based upon fiscal soundness for the sake of fostering sustainable growth and job creation.

This is the reason why I very profoundly wish and hope that all partners concerned will, in the coming days, live up to their responsibilities: the Commission, the Council, the governments concerned, so that we can not only preserve but reinforce the overall credibility of the euro area, and therefore growth.

Finally, the potential growth rate of the euro area must be increased. The current rate of potential output growth of the euro area is not sufficient to address the long-term challenges of Europe and, in particular, the high rates of unemployment. The full and rapid implementation of the Lisbon reform agenda on which we all agree must be supported and is wholeheartedly supported by the European Central Bank. It is the long-term prosperity of Europe's citizens that is at stake.