Yves Mersch: Monetary policy-making in the euro area

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, on the occasion of the Annual Meetings of the ACIIA (Association of Certified International Investment Analysts) and the EFFAS (the European Federation of Financial Analysts Societies), Luxembourg, 28 June 2006.

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Ladies and Gentlemen,

It is a pleasure for me to be here again today and to address such a distinguished audience of highly qualified professionals and specialists from the financial sector. Your work in developing financial skills and promoting professionalism and knowledge is commendable. It is also important for this financial centre.

The topic I have been asked to cover today is extremely broad. I will start by briefly outlining the institutional framework, strategy and objective of the Eurosystem. Subsequently, I will address what seems to be a permanent feature of central banking, and perhaps also of human destiny, namely the need to take decisions in an uncertain environment and based on imperfect knowledge.

1. Essential features of the Eurosystem's monetary policy

- Central Bank independence

  Crucial to this novel framework are the concepts of central bank independence and the assignment of a clear mandate to the ECB and the Eurosystem. The movement towards central bank independence is not limited to the euro area. Based on the experience gained during the inflation-prone period ranging from approximately the mid-1960s to the mid-1980s, a broad consensus emerged that price stability is the responsibility of the central bank, at least over the medium term, and that fighting inflation is best ensured by an independent central bank.

- The Eurosystem's mandate

  The Treaty is equally unequivocal when it comes to the ESCB's primary objective, which, according to article 105, "…is to maintain price stability". It is only "Without prejudice to the objective of price stability," that "…the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2."

  Summarising, one can therefore state that the independence of the ECB and the NCBs of the Eurosystem is particularly strong, as it is enshrined in an EU Treaty and therefore far more complex to modify than a national act of legislation. Similarly, the primary objective of the Eurosystem is clearly defined. By contrast, certain other central banks have to meet several objectives, including e.g. employment.

- The Eurosystem's definition of price stability

  The Treaty did not define the concept of price stability and in October 1998, the Governing Council of the ECB announced the following definition:

  "Price stability shall be defined as a year-on-year increase in the HICP for the euro area of below 2%. Price stability is to be maintained over the medium term."

  Every word in this definition is important and I would like to highlight the following points:

  - The ECB is one of the few central banks to have quantified its inflation objective. This contributes to anchoring expectations and makes it easier for the public at large and for financial markets to judge how the Eurosystem is delivering on its mandate.
  - By setting the upper bound for inflation above zero, the ECB takes into account the possibility of measured inflation overstating true inflation as a result of small but positive measurement errors. Such errors may, e.g., arise if prices are not

adequately adjusted for changes in quality. Moreover, a zero inflation rate for the Eurosystem as a whole would necessarily entail that if some euro area Member States experienced positive inflation rates, this would have to be compensated by deflation in other euro area Member States.

- Headline inflation, rather than some core inflation concept is taken into consideration. Oil prices are high largely due to demand effects from countries which at the same moment provide the euro area with low import prices and pressure on wages. Eliminating therefore oil from the price index would risk creating a downward pressure to the true inflationary pressures.
- Headline inflation is measured by means of an index of consumer prices whose statistical methodology has been harmonised for all EU Member States. This Harmonised Index of Consumer Prices, or HICP, is compiled by Eurostat.
- This definition makes clear that in implementing its monetary policy, the Governing Council does not look at individual countries, but at the euro area as a whole.
- Finally, in order to avoid a hectic and possibly pro-cyclical monetary policy, the ECB explicitly states that price stability has to be maintained over the medium term. This reflects the fact that monetary policy affects price developments with significant and variable time lags and that an economy is continuously subject to large unforeseeable shocks.

In May 2003, after more than four years of conducting monetary policy, the ECB undertook a thorough evaluation of its monetary policy strategy and, while confirming its initial price definition, it clarified its position by stating that "…it will aim to maintain inflation rates close to 2% over the medium term ". The goal is thus to keep inflation rates below, but close to 2%, emphasising that the ECB wishes to provide a sufficient safety margin against the risks of deflation.

- The Eurosystem's two-pillar strategy

The Eurosystem analyses the risks to price stability from two analytical perspectives, economic analysis and monetary analysis, which together constitute its two-pillar strategy.

The main purpose of this two-pillar strategy is to analyse all relevant information and to cross-check it from two different analytical points of view.

The economic analysis focuses on real activity and the interplay of supply and demand in the goods, services and factor markets in order to assess the short to medium-term determinants of price developments.

The monetary analysis focuses on a longer-term horizon, analysing the long-run link between money and prices.

With these two analyses, the ECB covers the entire chronological spectrum. The monetary analysis mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications from the economic analysis.

- Communication, transparency and accountability

The move towards central bank independence has been accompanied by great progress in the areas of accountability and independence.

The concept of **accountability** refers to the legal and political obligation of an independent central bank to justify and explain its decisions to its constituents, finance Ministers, analysts and academics as well as to the citizens and their elected representatives.

Transparency is more of an economic concept and can be defined as an environment in which the central bank provides in an open, clear and timely manner all relevant information on its mandate, strategy, assessments and policy decisions as well as its procedures both to the general public and to markets.

We have seen earlier that the Treaty gave a clear mandate to the ECB: to ensure price stability. Moreover, the Governing Council of the ECB quantified this primary objective and stated that it will aim to maintain inflation rates below but close to 2% over the medium term and explained in great detail its two-pillar strategy. Overall the ECB uses a combination of rules and judgment and its approach is one of constrained discretion.

2. Imperfect knowledge and the conduct of monetary policy

Since the introduction of the euro, inflation rates averaged slightly more than 2% in the euro area and this in a complex environment, characterised by a series of external and temporary shocks such as the bursting of the dotcom bubble, terrorist attacks, geopolitical tensions and a continuous increase in the prices of commodities, notably oil. However, since the introduction of the euro, inflation expectations – notably average long term expectations as measured for example by Consensus Economic Forecast or the Survey of Professional Forecasters- are firmly anchored at a level consistent with the Eurosystem's quantified inflation objective of below but close to 2%. Break-even inflation rates, defined as the yield differential between conventional nominal bonds and inflation-linked bonds, are slightly above 2% but this may reflect risk premia for the latter type of bonds due to liquidity constraints or technical factors. This anchoring of expectations at these levels is of vital importance, as it confirms the credibility of the Eurosystem and its forward-looking, medium term orientation and as expectations play an important role in shaping economic dynamics.

Taking decisions based under conditions of uncertainty is an unavoidable element, and perhaps even a characteristic ingredient, of central banking. This uncertainty stems from two elements.

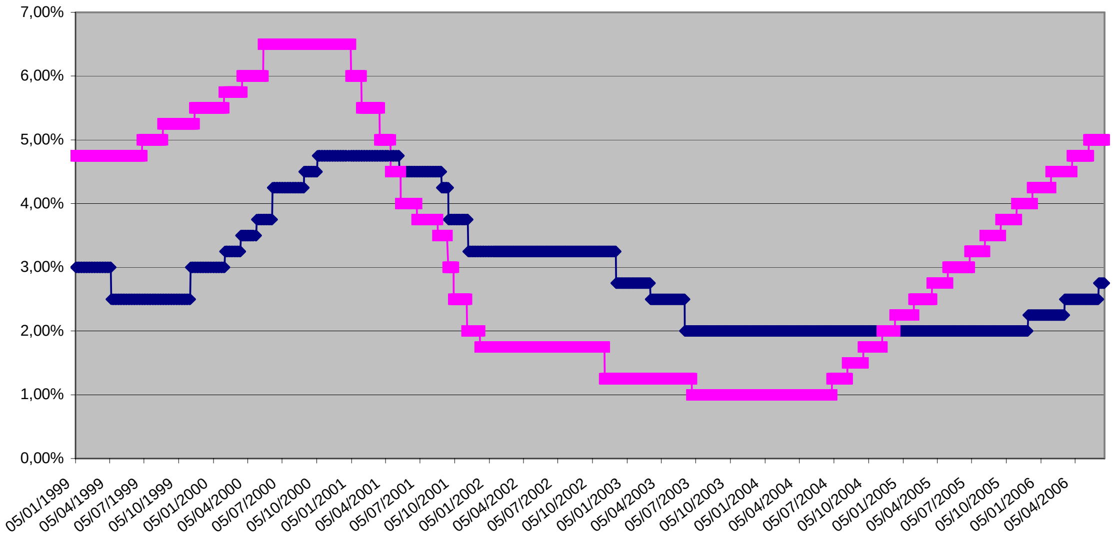
- First, economic knowledge is imperfect. There is no model, however sophisticated, which can faithfully replicate the exact functioning of the economy. More particularly, uncertainty clouds our knowledge of the transmission mechanism from interest rates to prices. This transmission is characterised by long, variable and uncertain lags. Our imperfect knowledge of the economy and the monetary transmission mechanism is further compounded by the delays with which economic and financial data become available, and sometimes also by the quality of these data, and this despite all efforts and progress made in the area of statistics.
- Second, the future is uncertain. Economic developments are continuously influenced by a large variety of demand and supply shocks. Fiscal policies may turn out different than expected. Exchange rates may move by more than warranted by underlying fundamentals. Commodity prices not only depend on supply and demand but also on geopolitical tensions. It is therefore a permanent challenge for the central bank to extract relevant information from diffuse data and events and to determine the appropriate path of monetary policy.

Since the introduction of the euro, the Eurosystem systematically analysed and cross-checked economic and monetary information under its two-pillar strategy, in the context of its forward-looking, medium-term framework.

- In 2001 the economic outlook deteriorated rapidly and medium-term inflation expectations were in line with the Eurosystem's objective. The rapid expansion of M3 during the 2001-03 period was not considered a threat to price stability, as it reflected a portfolio shift to less risky assets during a period of uncertainty. Consequently, it was possible to lower interest rates during this period.
- By contrast, in December 2005, after a lengthy period of unchanged interest rates, the Governing Council of the ECB decided to raise the rate on the main refinancing operation. The re-acceleration of real GDP growth in the first months of 2006 materialised, confirming the Eurosystem's views that economic growth is broadening and becoming more sustained. The June 2006 Eurosystem staff projections foresee growth in the 1.8-2.4% range in 2006 and between 1.3 and 2.3% in 2007. Risks to price stability are signalled by the 2 pillars of the monetary policy strategy. The first pillar, which indicates short-term to medium-term risks to price stability, shows inflation above 2% for that period. The monetary pillar, which signals medium-term to long-term risks to price stability, also indicates heightened risks to price stability as reported in the latest Monthly Bulletin. This is the case even if one would filter out a certain amount of noise in the statistics such as e.g. portfolio shifts. In this vein one could also discuss whether there is a structural break in trend velocity developments in the euro zone or whether the statistics are influenced by institutional product or regulatory developments. However, even if these elements are discarded, we would still find a large monetary overhang in the euro zone with heightened risks for unloading into transactions balances and therefore into inflationary pressures.

As President Trichet[1] remarked during a lecture at the Banco de España in early June, other central banks, such as the US Federal Reserve system, changed interest rates more frequently and by larger amounts during the 1999-2006 period than the ECB. This is very clear on this slide, which shows the MRO rates in blue and the target Federal funds rate in red. While phases of interest rate hikes and decreases broadly coincide on both sides of the Atlantic, the Eurosystem modified interest rates 18 times from 1999 until today, while Federal Reserve changes were about twice as frequent (35).

MRO and Federal Funds Target- January 1999 - June 2006



Does this mean that the Eurosystem is passive, or at least relatively more passive than other central banks?

In the opinion of the Eurosystem, activism cannot be quantified by the frequency or size of changes in interest rates. Activism refers to a strategy, not to policy implementation or changes in a policy instrument. A central bank should be as active as it needs to be in order to fulfil its mandate. What matters, is that the Eurosystem is permanently pursuing its primary objective and that it is constantly on alert to risks to price stability.

Moreover, how often and by how much a central bank should adjust interest rates in order to maintain price stability depends also on the structure of an economy and the type and frequency of shocks it is subject to. Several remarks can be made here.

- The euro area, compared with the USA, is more rigid and a central bank operating in a relatively rigid economy is able to deliver the same degree of monetary accommodation by adjusting its interest rate in more moderate steps than in a more flexible economy.
- The type of shocks affects the optimal reaction by the central bank. In case of a demand shock, forecasted inflation and output move in the same direction, leading the central bank to adjust rates more often and to a greater extent. By contrast, supply shocks cause more substantial transitory increases in inflation, possibly followed by second round effects. It is advisable for the central bank to adjust its policy instrument only to the extent needed to neutralise the anticipated more permanent effects of the shock on inflation over the following months or quarters. As, relative to the USA, the euro area seems to be exposed to demand shocks of smaller magnitude but to be hit more frequently by supply shocks[2], less frequent and less forceful changes in the policy instrument seemed appropriate.

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[1] J-C. Trichet, “Lecture on activism and alertness in monetary policy”, at the conference on Central Banks in the 21st Century, organised by the Banco de España, Madrid, 8 June 2006.

[2] F. Smets and R. Wouters, “Comparing shocks and frictions in US and euro area business cycles: a Bayesian DSGE approach”, Journal of Applied Econometrics, 20(1), January 2005.

- In addition, important structural elements of an economy, that influence the relation between inflation and the shocks to which an economy is subject are price flexibility and the anchoring of price setting. In the euro area prices are less flexible than in the US[3]. Retailers reprice their products every 13 months, compared to 6.7 months in the US. Stickier prices imply that adjustments to external shocks operate more through changes in output, income and employment than would be the case in a situation where prices are more flexible. They also imply an increased persistence of inflation. Nevertheless, despite these rigidities, inflationary shocks dissipate quickly in the euro area. An ECB study[4] shows that this paradox is explained by the fact that the impact of the ECB's inflation objective on the evolution of inflation outweighs the influence of past shocks and thus at least partly compensates for the added inertia resulting from a more rigid economic structure.

In other words, when the economy adopts the central bank's objective, the inflation process becomes less persistent and more forward-looking. All economic agents anticipate that the central bank will eventually bring inflation back to its pre-shock level and treat past inflationary shocks as transitory and inconsequential for the future. In an economy like the one of the euro area, where expectations are well-anchored, monetary policy can be more patient and focused on the medium-term when confronting a cost-push shock. The reverse side of the coin is that deviations of expectations from the inflation objective could prove more costly to correct at a later stage and therefore require a stronger policy response in terms of timing and or size.

Expectations that inflation will not diverge from its anchor afford some short-term flexibility to respond to economic disturbances. Establishing and maintaining its credibility is therefore of paramount importance for the central bank and requires commitment to a systematic strategy. The fact that the Eurosystem is particularly transparent by having a clearly defined primary objective, a quantified inflation target, a well-documented two-pillar strategy and has implemented its monetary policy in a consistent manner since 1999 explains this success in anchoring inflationary expectations, even in turbulent times.

Success in anchoring inflation expectations and facilitating the task of the public and the financial markets in predicting future monetary policy decisions is not, however, tantamount to pre-committing the Eurosystem to a certain policy path. Vigilance for the Eurosystem requires keeping all options open, including a quick change in policy if warranted by new information. There is no pattern of historical monetary policy decisions that could simply be repeated or mechanically extrapolated into the future.

The ECB will continue to check carefully all available information concerning risks to price stability under both the economic and the monetary analysis of its two-pillar strategy in order to avoid acting belatedly and to anchor inflation expectations.

Ladies and Gentlemen, I thank you for your attention and stand ready to reply to your questions.

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3 E. Dhyne, L. Alvarez, H. Le Bihan, G. Veronese, D. Dias, J. Hoffmann, N. Jonker, P. Lünnemann, F. Rumler and J. Vilmunen, "Price-setting in the euro area: some stylised facts from individual consumer price data", ECB Working paper No 524, 2005, see also M. Bils and P. Klenow in "Some evidence on the importance of sticky prices"; Journal of Political Economy 112, 2005.

4 L. Christiano, R. Motto and M. Rostagno, "Financial factors in business cycles", presented at the IMF-IRF Conference on DSGE Modelling at Policymaking Institutions: Progress and Prospects hosted by the Federal Reserve Board of Governors (Washington, 2-3 December 2005).