# John Hurley: The Eurosystem approach to monetary policy

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the Conference "The Global Interdependence Center Abroad in Ireland", co-organised by the Central Bank and Financial Services Authority of Ireland and the Irish American Business Chamber and Network, Dublin, 11-12 June 2007.

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## 1. Introduction

Ladies and Gentlemen,

Let me begin by saying how pleased I am to have the opportunity to participate in this conference. We in the Bank have co-organised this event and we feel that the high quality of the speakers and participants will ensure its success. It is both a networking exercise and an opportunity for participants to exchange views and hopefully gain further insights into financial and economic issues.

I have been asked to speak on the topic of monetary policy in the euro area. The single European currency project commenced towards the end of the 1980s and resulted in the adoption of the single currency eight years ago. Although the euro area is comparable to the United States in terms of population and GDP, it differs significantly in a number of respects. In particular, it is not accompanied by political union, nor is there a common language. These factors have not presented major difficulties and, by any standards, it can be said that EMU has been a success.

I will start by briefly recalling the background to the creation of the European single currency. I will then talk on the monetary policy strategy of the European Central Bank as well as its communication strategy. After briefly describing actual monetary policy since the launch of the euro, I will examine the benefits of monetary union for the euro area economy. Finally, I will refer briefly to the effects of the single currency on the Irish economy.

## 2. Background

The adoption of a single currency by eleven members of the European Union at the start of 1999 was an ambitious and unprecedented event. It was a very challenging task for all concerned. Despite considerable scepticism about the project in some quarters, it has been an undoubted success. Reflecting this, it has attracted two new members, Greece in 2001 and Slovenia in 2007. It has also resulted in the physical replacement of national currencies by euro notes and coin in 2002. At this stage, the general public in the euro area has effectively altered its mindset to think in terms of the euro rather than their previous national currencies.

How was this success achieved? One important impetus was the strong belief that the full benefits of the single market could only be enjoyed if the single market was complemented by a single currency. In 1992, the Maastricht Treaty set out a number of economic convergence criteria for the completion of EMU. In May 1998, eleven EU Member States were deemed to have met these price stability, public finance, interest rate, and exchange rate criteria and they proceeded to participate in the adoption of the euro as their single currency.

The speed of nominal convergence of the economic performance of these Member States in such a short period of time was very impressive. This occurred against a background of a crisis in the EMS that subsequently led to a substantial widening of the fluctuation margins for the bilateral EMS central rates. The fact that convergence occurred relatively quickly after such a turbulent episode was indicative of not only the political will to complete the monetary union project but also the flexibility of Member State economies.

## 3. The ECB's monetary policy strategy

The monetary policy strategy of the ECB comprises the following components:

- a quantitative definition of price stability;
- a medium-term orientation;

- a comprehensive analytical framework, based on a two pillar approach.

To begin with, let me discuss the quantitative definition of price stability, which currently the Governing Council defines as a euro-wide inflation rate of below but close to 2 per cent.

One of the primary reasons for adopting a quantitative definition of price stability was to anchor inflation expectations for the euro area. There are, however, other benefits associated with an explicit quantitative definition of price stability. It enhances transparency and facilitates the ECB in holding itself accountable for achieving its mandated price stability objective. A different, less specific definition of price stability could have led to uncertainty among economic agents, which in turn could have led to higher inflation expectations, higher market interest rates and increased risk premia. Indeed, the stability of market interest rates during the euro changeover period is testament to the success of the ECB's strategy.

The second aspect of the ECB's monetary policy strategy is its medium-term orientation, whereby the quantitative definition of price stability is to be achieved over the medium term.

This medium-term orientation reflects the fact that prices can be volatile in the short run for reasons outside the control of the ECB, or indeed any central bank, such as changes in indirect taxes and shocks to commodity prices, especially oil prices. It would therefore be sub-optimal for a central bank to stick rigidly to its inflation objective over very short-term horizons. This medium-term horizon also obviates the need for monetary policy to actively respond to short-term price developments or temporary economic shocks. It also means that the time horizon over which price stability has to be re-established following a shock can be tailored to the circumstances prevailing at the time and the nature of the shocks hitting the economy. In general, the horizon depends on a number of factors, such as whether the shocks are temporary or permanent and on their potential for becoming entrenched in pricing decisions. In any event, the central bank has to preserve its credibility, thus ensuring that expectations remain consistent with the declared policy objective.

The third aspect of the monetary policy strategy, and one which I will discuss in some detail, is the ECB's strategic framework. An important element of this framework is the "two-pillar approach" by which an economic analysis is cross-checked against an analysis of the development of monetary aggregates. By taking a broad approach to the interpretation of economic conditions, the ECB's strategy aims at adopting a robust monetary policy analysis in an environment that is typically uncertain.

The first pillar of the ECB's monetary policy strategy is the economic analysis. In taking monetary policy decisions, the Governing Council needs to have a comprehensive understanding of the prevailing and the prospective economic situation and must be aware of the specific nature and magnitudes of any economic developments threatening price stability. This analysis mainly focuses on the assessment of current economic and financial developments and the implied short- to medium-term risks to price stability, paying particular attention to the nature of shocks hitting the euro-area economy and their effects on cost and pricing behaviour.

There is a wide range of indicators examined by the Governing Council for the economic analysis, including product market indicators, financial market indicators, asset prices and exchange rate developments, as part of its overall economic analysis.

One of the elements influencing the Governing Council's assessment of economic and inflation prospects is the Eurosystem Staff Economic Projections. Macroeconomic models are used as inputs in the preparation of these projections. Economic projections are prepared by the Eurosytem staff on a quarterly basis and are based on a set of underlying macroeconomic assumptions. The Staff Economic Projections are one of many indicators employed by the Governing Council in reaching a decision on the stance of monetary policy.

The second pillar of the ECB's analytical framework is its monetary analysis, which complements and acts as a cross-check on the economic analysis. The growth rate of broad money (i.e., M3) provides a starting point for the assessment of monetary developments. However, given that the nature of the relationship between money growth and inflation is a long-run one, the ECB sees no mechanical link between short-run changes in the growth rate of the broad money stock and the monetary policy stance adopted by the Governing Council. There are many factors that may influence changes in the money stock in the short term. These may include, for example, portfolio shifts, financial innovations or changes in the yield curve.

The monetary analysis consists of a comprehensive assessment of the liquidity situation based on information about broad money growth along with its components and counterparts, especially credit aggregates. This is helpful for extracting the signal being sent by monetary developments, which is relevant for identifying the longer-run trend in inflation.

## 4. Communication

Transparency is a cornerstone of modern central banking. It serves two main purposes. First, it makes central banks accountable to the public and this is particularly important in an era of increased central bank independence. The second is related to the notion that monetary policy influences expectations and financial markets more effectively if the public has a better understanding of monetary policy objectives, procedures and decisions.

However, there are differences across central banks with regards to additional information provided on the day of a policy rate decision. The ECB is unusual among central banks of the advanced economies in holding a press conference on the day of a policy rate decision. The press conference consists of two components:

1. an introductory statement that explains in depth the rationale behind the monetary policy decision taken; and
2. a Questions and Answers session during which the President and the Vice-President are available to answer questions from the attending journalists.

This enhances communications by allowing media representatives the opportunity to digest in real time the information provided through the decision and the Introductory Statement of the ECB, to compare it with their own prior information, and to ask questions on those issues that need clarification.

Communication of the monetary policy stance and outlook for the economy is further supplemented by a more in-depth analysis of economic, financial and monetary conditions in the Monthly Bulletin of the ECB. Furthermore, members of the Governing Council regularly give interviews and speeches on the monetary policy strategy, stance and economic conditions.

With the ECB operating across 13 different cultures and a large number of different languages, the issue of communication brings many additional challenges than those that confront other central banks.

## 5. Monetary policy actions of the ECB: a short history

Let me say something about the monetary policy actions since the start of EMU. I think it is useful to distinguish four distinct phases.

The first phase, which was the early stages of EMU, was characterised by a combination of factors that had already been affecting the countries joining the euro area in 1998, namely downward risks to price stability. This led the Governing Council to reduce its monetary policy rate from 3 per cent to 2.5 per cent in April 1999.

The second phase was the period between late-1999 and late-2000 which was characterised by strong inflationary pressures, largely through high oil prices and relatively rapid monetary growth. The Governing Council undertook a series of monetary tightening measures during this period, raising interest rates by a total of 225 basis points.

The third phase was the period May 2001 to June 2003 when the euro area found itself in a period of subdued economic growth following a number of global shocks. With inflationary pressures abating, the Governing Council reduced interest rates by a total of 275 basis points between May 2001 and June 2003. This was followed by a lengthy period of slow economic recovery and market uncertainty. Expectations for economic growth remained moderate with the Governing Council leaving interest rates unchanged at 2 per cent until December 2005.

The fourth phase was the period since then which has seen uncertainty in global markets dissipate and the outlook for economic activity improve. The Governing Council has raised interest rates by 25 basis points on eight occasions between December 2005 and June of this year.

### *Remarks on current monetary policy stance*

Let me now turn to the current monetary policy stance. Our assessment throughout the last year and one-half was that the outlook for economic growth had improved and that the recovery would strengthen and broaden. This indeed has been what has happened. Another of our consistently repeated messages has been the need to guard against inflation risks coming from various sources, such as high and rising oil prices, increased pass-through to consumer prices, the risk of stronger than expected wage developments and, in the medium- to longer-term, strong money and credit growth. Our actions, in raising rates eight times, including the most recent increase, have been consistent with these messages.

With respect to the outlook for interest rates, I would emphasise that our future decisions are not predetermined and there is no pre-commitment to any future policy action. Our position is clear and has been consistent over time. As we indicated last week, we will monitor developments closely and act, as necessary, to ensure that risks to price stability over the medium term do not materialise.

The euro area economy has gone from strength to strength over the past 18 months. The economy expanded at its fastest pace for six years in 2006, and the medium-term outlook for growth remains favourable. The information we have for the first quarter of 2007 suggests that growth remained healthy. Looking ahead, the conditions are still in place for the euro area economy to grow solidly. External demand, while moderating, should still provide some support, while domestic demand seems set to maintain good momentum. Our assessment is that the risks to the outlook for growth are broadly balanced in the short term. However, over the longer term, there are some downside risks from oil price movements and global imbalances.

While inflation remains below 2 per cent, the rise in oil prices in recent months has meant that the dip in inflation that was expected in the first half of 2007 has not occurred. Over the remainder of the year, base effects are expected to push up the headline rate of inflation from September onwards. With regard to the medium- to longer-term outlook, upside risks remain. These risks are well known and relate to oil prices, the potential for increased pass-through and wage growth in a stronger economic environment and, in the case of the longer-run outlook, vigorous money and credit growth. The Governing Council has signalled that close monitoring of all these developments is essential to ensure that risks to price stability over the medium term do not materialise.

## 6. Benefits of EMU

The successful implementation of the stability-oriented monetary policy of the ECB has been of undeniable benefit to the euro area economy, both directly by maintaining price stability and indirectly from the lower volatility in real economy variables that price stability facilitates. The introduction of the common currency has also promoted increased financial and economic integration between the Member States of the euro area, thus increasing economic efficiency and providing fresh impetus for the deepening of the European Single Market.

The performance of the ECB in regard to its price stability mandate has been successful. In particular, long run inflation expectations have been within the ECB's definition of price stability. This underlines the credibility that the ECB has achieved since taking control of monetary policy. The volatility of inflation has also fallen. It nearly halved during the convergence period before the inception of the euro and has continued to fall since the adoption of the euro, despite the major economic shocks hitting the euro area economy during this period. There has also been a large fall in the average volatility of long-term consensus inflation expectations.

Monetary integration in the euro area has also been accompanied by, and given rise to, increased financial and economic integration. For example, the integration of money markets is complete and average overnight lending rates have fallen dramatically since the start of the convergence process. This high level of integration is also visible in related markets, such as the interest rate derivatives markets. The euro government bond market has also achieved a high level of integration with a large degree of convergence in yield spreads. Government bond yields in the Member States are now largely driven by euro-wide factors with marginal differences related to perceived credit risk. In addition to integration in these two markets, there is also significant evidence that euro area corporations are taking advantage of the possibility of raising funds from the full range of euro area investors, as evidenced by the growth in the euro corporate bond market.

## 7. Ireland and EMU

As regards Ireland's participation in EMU, there is a widespread view that this has been beneficial to the country. The European Commission's Eurobarometer survey shows that in Ireland over 70 per cent of respondents were of the opinion that the euro was beneficial. This view is buttressed by the fact that a strong performance of the economy has been associated with Ireland's membership of EMU.

Becoming a member of a monetary union was not a new experience for Ireland as we were already well versed in the functioning of monetary unions. Under the monetary arrangements with the UK, which lasted from 1922 to the end of 1978, the Irish pound remained tied to sterling on a one-to-one no-margins basis. Sterling was exchanged at parity in all banks with no charge and sterling circulated freely within Ireland.

When Ireland joined the European Monetary System when it was established in 1979, adherence to the Exchange Rate Mechanism of the EMS provided more flexibility, particularly under the wider bands, but nevertheless monetary policy remained relatively constrained. Moreover, fluctuations in the bilateral rate of the Irish pound with sterling frequently created uncertainty and consequently introduced short-term fluctuations in interest rates. Thus to a large extent joining EMU for Ireland was not as sharp a change in the monetary regime as is sometimes assumed.

Membership of EMU conferred immediate credibility on Ireland's macro-economic policy framework. There is little doubt that the cost of attaining such credibility would have been higher if Ireland had remained outside the euro area. Notwithstanding asymmetric shocks which could raise adjustment issues, it is probably true to say that the ECB provided a better policy response than that which would have prevailed under independent but uncoordinated monetary policies of individual countries.

The crucial issue for Ireland, as a regional economy in EMU, remains the manner in which it copes with the challenges of asymmetric shocks. In the last decade Ireland has had to face up to some such challenges. Notwithstanding these, the macroeconomic performance of the Irish economy in EMU has been very good. Since the adoption of the single currency, the average annual growth rate of real gross domestic product in Ireland has been the highest in the euro area. The annual growth rate over the period 1997 to 2006 was 7.2 per cent, some 5 percentage points per annum above the euro area average. This strong performance is in large part a result of high rates of growth of the capital stock (related in part to a reduction in risk premia), increases in the working age to population ratio, and improvements in labour and total factor productivity.

The challenges for Ireland in EMU remain the maintenance of a high level of living standards, ensuring the continuing competitiveness of the economy and adjusting to shocks originating outside the euro area. Ireland's economy and living standards have converged on those of the most advanced countries. However, there is a widespread consensus that lower productivity growth than that experienced in the last decade or so will lead to a slower growth in output over the medium term. This poses issues for containing domestic inflationary pressures. The social partners have a role in this by ensuring that pay increases take due account of productivity developments. Policies that promote competition, continue the development of the country's infrastructure, and that provide a framework that fosters research and development, innovation and entrepreneurship are all important for limiting inflationary pressures. Fiscal policy also has an important role to play in containing domestic demand. On the question of shocks originating from outside the euro area, the resilience of the economy depends on the capacity of both the product and labour markets to be flexible.

## 8. Conclusion

Before I finish, I would like to reiterate several elements that I believe to be of particular importance. Firstly, I would like to emphasise the broadly-based, multi-dimensional approach of the ECB's monetary policy strategy, encompassing a monetary analysis that is used to crosscheck the evidence from the economic analysis, and the ECB's commitment to a quantitative definition of price stability. The communication strategy of the ECB is also a noteworthy aspect of the overall monetary policy framework. The ECB has been innovative in communicating its monetary policy decisions to the financial markets and public in general, it being the first major central bank to outline policy decisions in real time through the monthly press conference that follows Governing Council meetings.

As I have indicated, the ECB has been successful in delivering low inflation and keeping inflation expectations in line with the quantitative definition of price stability. It has also been successful in lowering the volatility of inflation and inflation expectations, which has helped reduce volatility in other economic variables. The onset of monetary union has also provided momentum for further economic and financial integration in the euro area, thus deepening the single market.

With regard to the Irish economy, the euro has, to date, reduced risk premia and brought lower interest rates. These factors have contributed to Ireland's strong economic growth over the last decade but, on the downside, have also been associated with rapid credit growth and rising house prices. The key challenges for Ireland in the years ahead are to maintain its competitiveness so as to protect and sustain living standards and to deal with the effects of any asymmetric shocks hitting the euro area. In that regard, it will be necessary to continue to have flexible labour and product markets and to use domestic policy tools, insofar as is possible, to meet those challenges.

I would like to thank you all for your kind attention today and I will conclude by passing you back to Kathleen Hays.