Mr. Hannoun discusses the operational framework for EMU and the challenge of managing price stability Speech by the Deputy Governor of the Banque de France, Mr. Hervé Hannoun, at the Financial Times European Economic and Monetary Union Conference in London on 20/11/97.

I am delighted to take part in this discussion on the framework for the single monetary policy in Stage Three. I will address what I consider to be the two main categories of issues in this context: those related to monetary policy strategy on the one hand, and those related to the execution of monetary policy operations on the other hand; in other words, strategic and operational issues.

1. STRATEGIC ISSUES

What are the main strategic issues relating to the formulation of the single monetary policy? I will consider in turn:

- the final objective,
- the intermediate target,
- the role of the exchange rate as an indicator, and
- the starting level of interest rates in the euro area at the end of next year.

1.1. Final objective: a quantified definition of price stability

The final objective of the single monetary policy is clearly stated in the Maastricht Treaty: according to article 105, "the primary objective of the ESCB shall be to maintain price stability". Only a monetary policy geared towards the objective of price stability can create the conditions for durable and sustainable growth. To reach this objective, three conditions need, in my view, to be fulfilled:

- firstly, the monetary strategy should be set in a **medium-term framework**. More generally, the European policy mix should consist both of a medium-term stability-oriented monetary policy and of a medium-term fiscal policy aiming at a balanced budget (or "close to balance" as stated in the Stability Pact).[1] This medium-term stability-oriented policy mix is the best we can do to create the conditions for durable growth in the euro area. And it is now widely agreed in the European Union that the policy mix should not give the illusion that it can fine tune the economy;

[1] By urging governments to aim for a fiscal position close to balance or in surplus in the medium term, the Stability Pact enables them to let automatic fiscal stabilizers come into play during recessions without exceeding the 3% reference value. In short, it allows them to create a fiscal buffer during normal economic periods that can be drawn on if an asymmetric shock occurs.

- secondly, the strategy pursued should provide **a clear anchor to inflation expectations**. This implies the public announcement of a **quantified definition** of the final objective of price stability; for instance, the Banque de France aims at an inflation rate not exceeding 2%;
- thirdly, the strategy should be based on a **forward-looking approach**. This is because the transmission of monetary policy decisions to the economy takes place with relatively long lags. Estimates of these lags between interest rate changes and their effects on inflation vary between one and two years. As a consequence, central banks have to look ahead before they take monetary policy decisions. A case in point was the recent decision by several continental central banks, including the Banque de France, to raise their main refinancing rates on 9th October. This move was justified by the need to pre-empt inflationary pressures early enough, although **current** inflation remained low. In my view it is very important to make the public aware of the concept of the "pre-emptive strike", which is at the heart of central banking.

1.2. Intermediate target: more arguments in favour of monetary targeting, with a caveat

In order to provide an anchor to inflation expectations and to look ahead, central banks make public an **intermediate target** which they commit themselves to respecting. Announcing an intermediate target also enhances the accountability of the central bank. This is why Article 12 of the Statute of the ECB explicitly refers to decisions relating to intermediate monetary objectives as one of the main responsibilities of the Governing Council of the ECB. Two possible strategies have been selected by the EMI Council as potential candidates to be recommended to the ECB, namely monetary targeting and direct inflation targeting.[2] In the case of direct inflation targeting, the **inflation forecast** made by the central bank can be viewed as fulfilling the role of the intermediate target.[3]

Let me dwell a moment on the choice the ECB will have to make between direct inflation targeting and monetary targeting, unless it chooses to combine elements of both strategies. **Inflation targeting** stresses the responsibility of the ESCB for achieving and maintaining price stability. However, there are some difficulties in the process of forecasting inflation over the medium and longer term. As Mervyn King recently stated, "such a forecast cannot be a single number. It must be presented for what it is, namely a probability distribution".[4] Furthermore, inflation targeting could imply more formal cooperation with the Government since the latter is in a position to influence price developments. Finally, inflation targeting has admittedly proven useful in progressing towards price stability, as the experience of the United Kingdom has shown. Nevertheless, the track record of inflation targeting is fairly short and has mostly taken place in a context of world-wide disinflation.

Monetary targeting (in concrete terms, targeting a broad money aggregate such as M3) clearly indicates the responsibility of the central bank for developments that are more directly under its control and would therefore correspond better to the independence of the ECB. Moreover, it is based on observed information, which makes it more transparent. Finally,

[2] See the EMI report: "The single monetary policy in Stage Three - Elements of the monetary policy of the ESCB", February 1997.

[3] See, for instance, Lars E.O. Svensson, "Inflation forecast targeting : Implementing and monitoring inflation targets", European Economic Review 41 (1997), 1111-1146.

[4] Lecture given by Mervyn King at the London School of Economics on Wednesday 29 October 1997 to mark the tenth anniversary of the LSE Financial Markets Group.

monetary targeting by the ESCB would be in continuity with the strategy implemented by the Bundesbank since 1975 and by the Banque de France since 1976. However, this strategy hinges on the stability of money demand. Preliminary research has shown that EU-wide money equations often perform better than comparable national equations.[5] Nonetheless, this may provide no safe guidance for the starting period of EMU in so far as the move to Stage Three constitutes a change of regime which might lead to breakdowns in empirical relationships.

1.3. Indicators: an important role for the exchange rate and long term interest rate of the euro

It is likely that, while avoiding a "looking-at-everything" approach, the ESCB will closely monitor, in addition to the intermediate objective, a broad set of other economic and financial indicators to help assess the risks to future price stability. In this set of indicators, emphasis will probably have to be laid on the **exchange rate** and the **long-term interest rate** of the euro, for at least three reasons.

Firstly, the euro exchange rate and long-term interest rate will play an important role in shaping monetary conditions within the euro area, together with the level of short-term interest rates that will be steered by the ESCB. Secondly, although the degree of openness of the euro area will be much lower than is currently the case for any EU Member State, with "foreign" trade representing roughly 9% of GDP for the EU as a whole, the area will remain totally open to foreign capital flows. In that regard, I would like to stress that current holdings of French and German securities by non-residents, including cross-holdings, amount to 1,200 billion dollars. This highlights the importance of keeping a high level of confidence in the euro. Thirdly, in spite of the fact that the ESCB will inherit credibility from the participating national central banks, the ECB will have no track record of its own in targeting money or inflation. It will thus have to build up its reputation and pay due attention to those indicators that reflect most directly the level of confidence placed by investors in the euro.

Of course, as underlined above, the external value of the euro will not have the status of an intermediate objective and the ECB's strategy will not be based on exchange rate targeting.[6] However, any depreciating trend of the euro would feed domestic inflation through a rise in import prices and, by undermining investors' confidence, would contribute to the building of risk premia into the euro yield curve. This would have negative consequences for investment, competitiveness, growth and employment in the euro area. So there cannot be any "benign neglect" with respect to the exchange rate. A stable and strong currency contributes to lowering long-term interest rates, which play a crucial role in the financing of the economies in continental Europe.

All these reasons point to the need for a strong and stable euro, a currency that will be as credible as the franc, the guilder or the Deutsche Mark. The euro must be, and will be, rock solid. Therefore the exchange rate of the euro, even if not targeted as such, will undoubtedly play an important role as an indicator in the conduct of the single monetary policy.

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[5] See, for instance, "Money Demand in EU Countries: A Survey", by F.X. Browne, G. Fagan and J. Henry, EMI Staff Paper n° 7, March 1997.

[6] This is different from the current stance in France, where the stability of the exchange rate vis-à-vis the most credible currencies within the ERM is one of the two intermediate targets of monetary policy.

1.4. The starting level of key interest rates in the euro area

Let me say a few words on another strategic question: what will be the starting level of key interest rates in the euro area thirteen months from now?

Futures contracts on short-term interest rates reflect the market's expectations on this issue. But of course don't expect a central banker to answer this question, one year in advance. I will just mention the Banque de France view on the rationale that should be behind the determination of the starting level of the euro area short-term rates.

As you know, we currently observe interest rate differentials between the "core" and more "peripheral" currencies participating in the exchange rate mechanism. Although these spreads have been dramatically reduced in the past two years, due to the remarkable convergence of inflation rates throughout the European Union, some interest rate differentials still exist. They can be attributed partly to differing positions in the business cycle, and partly to differences in credibility.

Cyclical differences within the potential euro area should not be overestimated. There is, all in all, a relatively high degree of synchronisation in the business cycle in continental Europe. The convergence criteria laid down in the Maastricht Treaty certainly played an important role in fostering this synchronisation. Moreover, in the future, differences in cyclical developments will gradually be reduced as policies, structures and behaviour will become more and more similar. Lastly, some persisting differences may well be tolerated as is currently the case between the various regions of the same country or, for instance, between the various member states of the USA.

Credibility differences between "core" and "peripheral" currencies result from the different lengths of the track records in terms of stability-oriented policies. It is not the same to have reached an inflation goal of less than 2% for one year as for ten years. One of the benefits that the "peripheral countries" could reap from participating in the first wave of monetary union is to achieve the level of interest rate of the most credible currencies without having yet built up a very long track record.

I would like to underline that in Europe, we are not converging towards a kind of average of the market interest rates of the potential euro area. One has to understand that the philosophy of EMU is to organize the convergence of the European countries towards the best possible level of monetary credibility and therefore towards the benchmarks in terms of interest rates. As Mr. Trichet recently stated, **"convergence is a benchmarking concept"**, not an averaging process. Convergence does not mean that the "core" currencies' interest rates should go up towards irrelevant "average levels", but that the interest rates of more "peripheral" countries should progressively converge towards the benchmark level.

This benchmark level is currently given by the intervention rates of the Bundesbank and of the Banque de France, both at 3.3%. But of course the benchmark level one year from now could be different from 3.3%.

2. OPERATIONAL ISSUES

How will the ESCB operate? As you know, central banks implement their policies through the creation and destruction of central bank reserves, of which they are monopoly suppliers. This is done in the framework of domestic credit operations as well as foreign exchange interventions. Credit operations are conducted at maturities that extend overnight or beyond, to implement monetary policy, or on an intraday basis, to provide liquidity to payment systems. Therefore, I will consider in turn monetary policy operations, intraday credit operations and foreign exchange operations. I will focus on the following issues:

As regards monetary policy operations, how will a single money market rate be attained and what will be the degree of interest rate volatility that the ESCB will be willing to accept? As regards intraday operations, how to cope with the risk of spillover from intraday credit into overnight credit? As regards domestic credit operations as well as foreign exchange operations, how will the principle of operational decentralisation be applied within the ESCB?

2.1. Monetary policy operations: a short-term money market rate as operational target

To implement the single monetary policy, the ESCB will pursue an operational target that will normally be a short-term money-market interest rate. Two issues deserve close attention in that regard: the singleness of the money market on the one hand, and the volatility of the interest rate that will be targeted on the other hand.

2.1.1. Single money market rate

The single monetary policy will be characterised by the singleness of interest rate levels in the interbank market: from the 1st January 1999 on, a single money-market interest rate will apply throughout the euro area for a given maturity. The issue is, thus, how to attain this single interest rate level. Two requirements will have to be met for that purpose. The first requirement is that, in the context of a single monetary policy that will be implemented in a decentralised manner, there should be a very high degree of harmonisation of instruments and procedures. The EMI and central banks are working relentlessly to this aim. The second requirement lies in the integration of interbank markets and payment systems.

As far as **interbank markets** are concerned, two factors should play a key role:

- the first factor relates to the various rules market operators have to abide by. These rules apply to counterparts, market makers, brokers, rating agencies and market enterprises such as clearing houses. They take the form of codes of conduct, regulations, master agreements and market standards. An appropriate degree of harmonisation of these market rules should be reached under the aegis of central banks and prudential authorities;

- the second factor, the use of a single range of reference interest rates would guarantee the transparency of the euro money market. In this respect, short-term maturities are of special interest to central banks. This justifies that they intervene to some extent in the process of elaborating these indicators. As a matter of fact, the EMI has recently agreed that the ESCB should sponsor the computation of an **overnight reference rate for the euro area**.

As regards **payment systems**, the TARGET system will also contribute to the rapid emergence of a unified money market throughout the euro area. TARGET will connect the domestic real-time gross settlement (RTGS) systems operated by the national central banks. It will enable participants to make totally safe cross-border settlements in euro, in real time and at a low cost, thereby facilitating interest rate arbitrage. All large-value payments related to monetary policy operations will have to process through TARGET. A common closing time for domestic RTGS and the harmonisation of conditions under which intraday liquidity will be provided by national central banks within the euro area should also help prevent any risk of segmentation of the single money market.

2.1.2. Interest rate volatility

The EMI has described in various publications the **set of monetary policy instruments** that will be made available to the ESCB.[7] This set will comprise **open market operations, standing facilities and minimum reserves**. It should fulfil two basic functions: firstly, to enable the ESCB to control efficiently its operational target; secondly, to signal the ESCB monetary policy stance. It should also be consistent with the requirement laid down in the Maastricht Treaty that the ESCB should act in accordance with the principle of an open market economy with free competition, favouring the efficient allocation of resources.

In practice, the concrete design and use of monetary policy instruments will depend crucially on **the degree of volatility of the short-term rate chosen as the operational target that the ESCB will be willing to accept**. This volatility will in turn depend on several factors:

- the **width of the corridor** defined by the two standing facilities available to absorb or provide liquidity (the deposit facility for the floor and the marginal lending facility for the ceiling). Under normal circumstances, the two facilities will bound the overnight interest rate. They will operate at the overnight maturity and will be accessible at the discretion of counterparties and for unlimited amounts, provided, in the case of the marginal lending facility, counterparties can supply adequate collateral. A very narrow corridor, allowing very little room for the functioning of the money market, would not be strictly in line with market principles. On the other hand, a very broad corridor would not help contain excessive market volatility. As a consequence, the width of the corridor is likely to be set pragmatically (currently, it is around 2% for most central banks that operate an interest rate corridor similar to the one planned for the ESCB);

- the **frequency of fine tuning operations** could be a more discriminating factor for interest rate volatility. Very frequent intervention of the ESCB in the money market would not, in my view, be fully consistent with market principles. Moreover, excessive intervention might complicate the extraction of information from movements in market interest rates, especially at the maturity at which the ESCB would intervene. Intensive recourse to fine-tuning operations might also deprive regular refinancing operations and standing facilities of their signalling effect and be conducive to a centralisation of monetary policy operations;

- provided they are set at a sufficient level, and include an averaging provision, **reserve requirements** constitute an efficient buffer against liquidity shocks ; this would help stabilize short-term interest rates over the maintenance period. In turn, setting a fairly high level of minimum reserves might require remunerating them in order not to induce significant delocation or disintermediation;

[7] See the two EMI reports “The single monetary policy in Stage Three – Specification of the operational framework”, January 1997, and “The single monetary policy in Stage Three – General documentation on ESCB monetary policy instruments and procedures”, September 1997.

- **enhancing the signalling effect of the main refinancing operations** should also contribute to lowering interest rate volatility. This may best be achieved through the normal conduct of **fixed-rate tenders**, which send clear signals to the market, rather than variable-rate tenders. The latter may nevertheless be useful in certain circumstances where the ESCB wishes to gauge market sentiment;

- finally, the **communication policy** of the ESCB could also play a role in smoothing interest rate volatility. The ESCB will have to publish weekly a consolidated balance sheet. It will also publish the results of its tender operations. It could equally wish to release daily aggregate data on the reserve holdings, if averaged reserve requirements are in place, and on the use of the two standing facilities, as measured in both cases at the end of the previous day.

2.2. Intraday operations: the spillover from intraday credit into overnight credit as a borderline case

To ensure the smooth functioning of the TARGET system, the national central banks will provide intraday liquidity to participants in the real-time gross settlement systems. This will be done in the form of fully collateralised intraday credit operations, in the sense that a credit extended during the day falls due before the end of the day. From a monetary policy point of view, such operations create the risk of a spillover of intraday credit into overnight credit that would undermine the control of the ESCB over the euro monetary base. In other words, the spillover of intraday credit into overnight credit in the books of the central bank can be viewed as a borderline case between payment systems and monetary policy issues.

Within the euro area, this risk will be limited as end-of-day debit positions will be automatically considered to be a request for recourse to the marginal lending facility, i.e. an ESCB monetary policy instrument that bears a penalty interest rate.

Outside the euro area, a problem arises as the RTGS systems of non-participating countries will be connected to TARGET, whereas no central bank currently gives non-residents access to its monetary policy instruments. As a consequence, different mechanisms are being prepared in order to prevent intraday credit, if granted to non-euro area NCBs, from spilling over into overnight credit. These mechanisms include the limitation, possibly to zero, of the amount of intraday liquidity non-euro area NCBs could receive, a system of penalties and sanctions applied in case of overnight overdrafts and an early closing time for participants in RTGS systems in non-euro area countries. The decision on which mechanisms to implement will be taken by the ECB.

2.3. Foreign exchange operations

Foreign exchange operations include foreign reserve assets management on the one hand, foreign exchange intervention on the other hand.

The ESCB will hold and manage two different types of foreign reserve assets:

- those that will be transferred from the national central banks to the ECB; according to the Statute, the ECB shall be provided with such foreign reserve assets up to an amount equivalent to euro 50 billion;

- and those that will be kept by the national central banks; the management of these foreign assets will be subject to guidelines issued by the ECB to ensure that the operations of national central banks do not interfere with the monetary and exchange rate policies of the euro area. These guidelines will include prior approval by the ECB for transactions exceeding thresholds to be specified and will also apply to member states' transactions with their foreign exchange working balances.

The ESCB will have the technical capacity to conduct, if need be, foreign exchange intervention in order to counteract excessive or erratic exchange rate fluctuations of the euro against the major non-EU currencies (e.g., the US dollar).

The need for intervention could also arise either in the context of G7 concerted operations or within the framework of the ERM II. To this end, the ESCB will use the pool of foreign assets transferred from the NCBs to the ECB.

The framework that has been designed for domestic as well as foreign exchange operations allows the ESCB to build on the expertise that NCBs have acquired over the years and to make an extensive use of existing operational capacities in NCBs (dealing room, front office, back office). Common sense dictates making use of equipment, human resources and expertise currently available at NCBs.

2.4. A decentralised execution of operations

A key feature of the single monetary policy is indeed that it will be decided in a centralised manner, by the Governing Council of the ECB, and executed in a decentralised manner, by the national central banks. In my description of operational issues within the context of the single monetary policy, I have made numerous and concrete allusions to this reliance of the ECB on the national central banks, in the areas of monetary policy, payment systems and foreign exchange operations. This organisation scheme of the ESCB is in line with the principle of subsidiarity laid down in the Maastricht Treaty. According to this principle, the ESCB shall have recourse to the national central banks to carry out its operations, to the extent deemed possible and appropriate. Consistently with this principle of decentralisation in the execution of the ESCB's operations, the counterparties (credit institutions) will keep their accounts with the NCBs.

Operational decentralisation within the ESCB will be in the very interest of the System. In this regard, let me quote the President of the EMI, Mr. Duisenberg: "Reliance on the infrastructure and operational experience built up by the national central banks will prove a valuable asset. Given that the ESCB needs to be cognisant of differences between financial market participants and structures in the EU, operating through the national central banks will ensure that it has the best possible knowledge of market conditions throughout the euro area".[8]

The credibility of the ECB as the decision-making centre will by no means be undermined by this decentralised scheme. It will not depend on the technicalities in the execution of operations. The credibility of the ECB will crucially depend on its ability to

[8] Speech by the President of the European Monetary Institute, Dr. W.F. Duisenberg, at the conference on "European Monetary Union : Prospects for European Financial Markets", held in Paris, 22 October 1997.

adamantly pursue its strategy aiming at price stability and on its fortitude in resisting any pressure to deviate from this strategy.