

Ms. Hämäläinen discusses achieving a credible currency for Europe Address by the Governor of the Bank of Finland, Ms. Sirkka Hämäläinen, at the Frankfurt International Banking Evening on 5/5/98.

...First of all I would like to thank the hosts of this evening for giving me the opportunity to address this distinguished audience in these historical surroundings. It is a great honour and privilege for me.

With the historical decision reached at last weekend's European summit, we now know that a common monetary policy will become reality for eleven EU countries at the beginning of next year. A long, intense process - a process that has had its doubters and critics along the way - has now passed an important milestone.

Setting forth on this historical project was in itself a tremendous achievement, but the real challenges still lie ahead. The participating countries must now make this project succeed and achieve its intended objectives. The project must deliver unquestioned monetary stability and efficiency to the euro-area, and thereby provide a solid basis for growth and employment in Europe.

As part of the overall stabilization and convergence achieved by the participating countries and as a result of the strengthening of market confidence, we have seen wide convergence in interest and exchange rates. This will ease the transition to a single monetary policy, but the crucial question remains: How do we make the euro credible from the start, so that the ESCB doesn't have to resort to an unnecessarily tight monetary policy?

At the end of the day, strong credibility is what ensures low inflation expectations, low inflation and low interest rates.

Credibility is built up from many elements, building blocks if you will. Even though the ECB starts its operations without a track record and without its own history of credibility, a number of these critical elements already exist. All in all, I would like to identify seven building blocks that are important for the ESCB's credibility.

1. The first building block is the credibility the ECB may inherit from the national central banks of the participating countries. All NCBs in the euro area have conducted monetary policies aimed at price stability and convergence in accord with the principles of the Maastricht Treaty.
2. The second building block is the ESCB's uncontested independence. This will give institutional credibility from the outset.
3. The third building block is the transparency and clarity of the ECB's strategy and aims. The ECB's primary final objective is price stability. This final objective will before 1999 be operationalized and quantified in a way that is meaningful and understandable to the markets and the public at large.

The ECB's monetary policy will be geared towards a "domestic" objective, internal price stability within the euro area while the euro is allowed to float against other world currencies. The fact is that the share of foreign trade in GDP for the euro area is approximately the same

as for the US, about 10 per cent, so the exchange rate will probably not have much of an impact on the euro area price stability or the monetary policy stance, even indirectly.

Certainly, it would be expedient to quantify and to announce the target “price stability”, for example, in the form of a target range or an approximate value. This, and what kinds of intermediate monetary aggregate targets could or should be used to communicate the monetary policy stance to the markets, the public and policy-makers, are still under consideration. I will therefore not go further into this topic, except to note that formulating monetary policy strategy and the definition and specification of its policy will be one of the first and most important issues on which the ECB must decide.

The problem of intermediate targets is that we lack Europe-wide empirical evidence on the stability of demand-for-money functions and on the monetary policy transmission mechanism in general. What we can say with certainty at this point - and this is not too productive - is that the analysis of the monetary policy transmission mechanism will be a truly challenging task. The financial market and structural changes produced by the single currency, as well as the general continuous structural changes in the financial markets due to globalization, are transforming the transmission processes.

All the central banks carefully distill vast amounts of data and examine many different indicators before they decide on policy. Thus, quantitative targets are not perhaps so important for the internal decision-making process of the central bank. But they are very important for communication with the markets and the public. How useful they are for this purpose depends very much on their predictability.

4. The fourth building block - which partly covers the previous one - is the wider overall openness of the central bank towards the markets, the public and policy-makers, not only in its strategy and targeting but also in its analyses and reasoning behind its decisions.

A high degree of market transparency is natural for any central bank operating in a market environment, because transparency essentially increases the efficiency of monetary policy. Without doubt, the ESCB has to, and will, consider all possible means and channels to achieve it.

Another central aspect of openness is what is loosely called “democratic accountability”. Confidence of the public and the political decision-making bodies that represent the public is of utmost importance for the credibility of an independent central bank. This confidence can only be achieved if information provided by the central bank to the public is clear, and if there is a healthy dialogue between the central bank and political decision-making bodies.

The Maastricht Treaty provides a framework for accountability at the European level; national legislation of the member states provides a similar framework for national accountability. The euro will require the acceptance and support of citizens and policy-makers in each participating member state. Thus, accountability at the national level will be very important.

In practice, democratic accountability should be the outcome of constructive communication between the central bank and political decision-making bodies - connected with complete central bank independence. There should not be any genuine conflict between the central bank on the one hand and the other policy-makers and the public on the other hand because they all share a common ultimate goal under EMU, monetary stability and economic growth.

5. The fifth building block, and one of the most important elements in the credibility of the euro, is the stance and discipline of fiscal policies, both in individual member states and in the euro area as a whole.

Fiscal policy affects credibility in two ways. The first has to do with how well national fiscal policies cope with differences in the business cycle and in the monetary policy transmission mechanisms of the member states. Under a single monetary policy, national fiscal policies need to be far more active and flexible than at present to deal successfully with country specific growth and inflation differences. Both room to manoeuvre at the national level and the Stability and Growth Pact explicitly demand that the public finances of the member state are balanced and healthy.

The second aspect of fiscal policy, closely connected to the first, is the overall degree of fiscal policy discipline in the euro area. Curbing inflation expectations and achieving the inflation target are the more easily attained with low interest rates, the more disciplined the fiscal policy at the European level.

It is of vital importance that a close and constructive dialogue is organized and established between the ministers of finance of the participating countries (EURO-11) and the European Central Bank. Such a dialogue does not in any way endanger the ECB's independence to pursue its legislated objective price stability.

Simultaneously, the role of national central banks and their dialogue with the national fiscal policy authorities will continue to be essential; in achieving an appropriate monetary and fiscal policy mix at the European level, and in ensuring balanced economic performance in each country under the single monetary policy.

6. The sixth building block of credibility for the European Central Bank and the stability of the euro, is a high standard of economic and monetary analysis within the ESCB. High-quality work encourages confidence in the expertise of the system in a new environment where this analysis and know-how must cover the entire euro area. Here, the skills, knowledge and expertise accumulated in national central banks will be put to good use in the preparation of the single monetary policy.

As you have noticed, I have repeatedly stressed the importance of national central banks in the European System of Central Banks. Let me say very firmly that I am not doing it out of parochial concerns or motives. What we need is an ECB that is strong and efficient. In today's eleven-country constellation the ECB needs to mobilize the support of the national central banks.

The governors of the national central banks will have a central role in the Governing Council of the ECB where decisions on monetary policy as well as decisions on systems and institutional arrangements will be made. Operations and transactions will be decentralized and carried out in the national central banks. The skills and accumulated knowledge of the national central banks will form an integral part of the preparation of joint decisions. The NCBs will also play a major communications role by providing information at the national level and helping to define the fiscal and monetary policy mix for both the national and the entire euro area. And finally, the national central banks will bear a great responsibility in

ensuring the legitimacy of the independent ESCB through their contributions to transparency and democratic accountability.

7. While I stress here the role of the national central banks, I also want to stress very strongly that the seventh, and one of the most important building blocks of the credibility and stability of the euro and the efficiency of the single monetary policy will be the ability of the governors of the national central banks to base their analyses, actions and decisions on the interests of the euro area as a whole.

Although one of the tasks of any governor of a national central bank is to bring national information and viewpoints into the decision-making process, there is no conflict with the interests of the euro area.

Adopting a euro area-wide viewpoint will be a demanding and immediate challenge for the European System of Central Banks. This challenge makes me believe that it is not a good idea to publish the minutes and the voting positions of the Governing Council meetings, even though transparency and accountability of the European System of Central Banks are very important. The publication of the discussions and voting positions could easily lead to dramatization of national differences of opinion at the expense of euro-level views.

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During the 1990s, Finland has gone through severe adjustments. We have consolidated our public finances and achieved credibility for our monetary policy. For us Finns, the single monetary policy is a natural continuation of this process. In global, expectation-driven financial markets, a small country has poor possibilities to ensure its exchange rate and interest rate stability, even with a highly disciplined fiscal and monetary policy and sound economic fundamentals. For us, the stability and credibility that we expect from EMU, and its discipline, are of vital importance.