Mr Duisenberg reports on monetary policy in the euro area

Speech by the President of the European Central Bank, Dr Willem F Duisenberg, at the New Year's reception organised by the Deutsche Börse, at the Chamber of Commerce and Industry, Frankfurt/Main, on 25/1/99.

Thank you for the invitation to speak at this New Year's reception. 1999 is a special year: the year in which the euro was launched, and the year in which it will have to become a stable currency. This is the challenge which lies ahead.

The introduction of the euro was a very happy event for all involved. The euro is present on all major financial markets around the globe. Currency trading in euro has commenced and for three weeks now shares have been denominated in euro on most European stock exchanges. Although not yet embodied in the physical form of new banknotes and coins, there is no doubt that the new currency is set to play an important role, both in the euro area and beyond.

The euro is a symbol of the achievements of Europeans in the pursuit of common goals. It is unprecedented in European history. After years of intensive preparations and successful efforts towards convergence, the single monetary policy for the entire euro area is being determined by the European Central Bank (ECB). The Governing Council of the ECB, which comprises the Governors of the 11 national central banks of the participating Member States plus the six members of the Executive Board of the ECB, has assumed this responsibility and is in charge of monetary policy decisions for the euro area. Decisions by the Governing Council will be implemented via the Eurosystem - that is, the ECB and the 11 participating national central banks (NCBs).

Indeed, the introduction of the euro marks the culmination of much successful preparatory work over a period of many years. This has been reflected in the very positive and confident way in which financial markets have received the euro in the first three weeks of Monetary Union. Moreover, the enormous technical and logistical challenges posed during the changeover weekend at the start of the year have been surmounted.

Monetary Union offers a unique opportunity to establish and maintain price stability within the euro area. It promises a credible and lasting environment of price stability for almost 300 million people. Price stability is at the core of the "stability culture" that we are seeking to establish throughout Europe. By fulfilling the unequivocal commitment of the Governing Council of the ECB to maintaining price stability in the euro area, we shall ensure that the single monetary policy contributes as much as possible to economic welfare in the broadest sense.

At the same time, national fiscal authorities and general economic policies also have to demonstrate their commitment to the creation of this stability culture in Europe. In this context, the Stability and Growth Pact is a crucial element. Its aim is to foster the pursuit of disciplined and sustainable fiscal policies in the euro area. In so doing, it can make a significant contribution to the establishment of favourable conditions for sustained economic growth and high employment in the medium to long term. It would be counterproductive if national fiscal policies started to discontinue their efforts in the light of the achievement of Monetary Union and the currently positive price outlook. I am not fully convinced that consolidation efforts are currently being undertaken with sufficient determination in all participating Member States.

Monetary policy alone - however well designed and implemented - cannot solve Europe's economic problems. Appropriate structural reforms implemented by national governments are of the utmost importance. Much progress is required in this broad area. Moreover, continued wage moderation in both the public and private sectors would contribute to the reduction of the unacceptably high level of unemployment in many parts of the euro area.

Unemployment in the euro area is largely structural in origin. Implementing too lax a monetary policy will not solve this problem, but rather exacerbate it over the medium term, as inflation distorts investment and savings decisions, raises the risk premium in long-term interest rates and undermines the allocative efficiency of the price mechanism. Only effective structural policies that improve the flexibility and efficiency of labour and goods markets can reduce unemployment in a successful and lasting manner. I appreciate that such reforms are not always easy, not least because the benefits which they yield occur mainly in the medium to long term. However, they are unavoidable. In those euro area Member States that have taken up the challenge of structural reform, unemployment has fallen significantly. Other euro area Member States should and must take note: structural reform throughout the euro area is fundamental to the success of Monetary Union and to improving Europe’s economic performance. In this respect, we may also be able to learn something by looking at the reasons behind strong employment growth and low unemployment in some of the Member States of the European Union and in the United States, in particular regarding the flexibility of labour markets and the incentives to create and accept new jobs.

Today, I shall describe the main features of the stability-oriented monetary policy strategy of the Eurosystem which underlie our single monetary policy. Against this background, I shall briefly explain the recent monetary policy decisions adopted by the Governing Council of the ECB. Finally, I shall summarise how we currently see the outlook for maintaining price stability in the euro area.

I. The stability-oriented monetary policy strategy

The Treaty on European Union, commonly referred to as the “Maastricht Treaty”, assigns the European System of Central Banks (ESCB) the primary objective of maintaining price stability in the euro area. In order to steer expectations of future price developments, the Governing Council has announced a quantitative definition of its primary objective. This clarifies how the Treaty’s mandate is interpreted by the Governing Council and gives the public clear guidance concerning its assessment of the success of the single monetary policy.

Price stability is to be maintained over the medium term. According to the published definition, price stability has been defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Neither would deflation - that is, a persistent fall in the price level - be consistent with price stability. The annual rate of inflation in the most recent available data of around 1%, measured on this harmonised basis, is consistent with the definition of price stability. The Eurosystem has therefore enjoyed the good fortune to assume authority over monetary policy in the euro area in an environment of price stability, owing to the successful process of disinflation and convergence achieved within Europe over the past decade.

Monetary policy needs a forward-looking, medium-term orientation. This takes into account the fact that monetary policy affects the price level only with variable, usually long and unpredictable time lags. It is not able to control all short-term movements in the price level. To maintain price stability, we have chosen a distinct monetary policy strategy, one that reflects the special circumstances that exist at present as well as those likely to prevail in the foreseeable future. The chosen strategy ensures as much continuity as possible with the former strategies of the NCBs. At the same time, it gives due consideration to the unique situation which will prevail in the early years of Monetary Union.

The stability-oriented monetary policy strategy rests on two “pillars”. The first pillar is a prominent role for money. This is deemed to be important on account of the essentially monetary origins of inflation over the longer term. The second pillar of the monetary policy strategy is a broadly based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole. The Governing Council recognises that it is important, in parallel with the assessment of monetary growth, to look at a wide range of financial and other economic indicators, including economic forecasts. This systematic analysis of all other relevant information about economic and financial conditions will ensure that the Governing Council is as well-informed as possible when taking monetary policy decisions.

Monetary developments can reveal useful information about future price developments and thereby offer an important compass for the conduct of monetary policy. Therefore, it is absolutely essential for any central bank entrusted with the task of keeping prices stable to analyse and monitor the developments of monetary aggregates closely.

Consequently, the Governing Council of the ECB has announced a quantitative reference value for broad monetary growth as measured by M3, which should, under normal circumstances, give some indication of future inflationary pressure. The choice of M3 as an aggregate is supported by empirical evidence regarding the long-run stability and leading indicator properties of this aggregate. Moreover, conceptual arguments pointed to the considerable importance of including in the monetary aggregate those assets which have a high degree of substitutability with narrower definitions of money. Therefore, in addition to currency in circulation and deposits, repos, units or shares of money market funds and money market paper as well as short-term debt securities, all of which are close substitutes for more traditional bank deposits, have also been included in this definition.

The first reference value for M3 growth has been set at an annual rate of 4½%. This reference value is consistent with the maintenance of price stability over the medium term, while allowing for sustainable output growth and the trend decline in the velocity of circulation of M3. In setting the reference value for monetary growth, the Governing Council has taken account of various factors and emphasised its medium-term orientation. First, the Governing Council is committed to maintaining price stability according to the definition enshrined in the Treaty on European Union. This requires increases in the HICP for the euro area of “below 2%”. Second, the Governing Council takes the view that a figure in the range of 2% to 2½% per annum for the trend growth in real GDP in the euro area appears to be reasonable. Third, the uncertainties concerning short-term developments in velocity linked to the start of Stage Three have led the Governing Council to assume that the medium-term trend decline in velocity lies approximately within a range of ½% to 1% each year. This range reflects historical experience over the past 20 years.

Substantial or prolonged deviations of current monetary growth from the reference value should, under normal circumstances, signal risks to price stability in the medium term. Monetary policy does not react to deviations of monetary growth from the reference value in a “mechanistic” way. In the first instance, such deviations will be thoroughly analysed to infer any signals which they may offer about the prospects for price developments. If the deviation points to a threat to price stability, monetary policy will react in a manner appropriate to counter this threat, rather than attempt to eliminate the deviation of monetary growth from the reference value in the short term.

Although monetary data contain information which is vital for monetary policy decision-making, monetary developments alone will not constitute a complete summary of all the economic information necessary to take appropriate policy decisions. There is a clear need for the Governing Council to look at a wide range of other economic and financial indicators.

At the same time, relying on a single forecast that attempts to summarise all the information available from a wide range of indicators would be misguided. The Governing Council does not react mechanistically to a single variable - whether this be a forecast, the exchange rate, unit labour costs or fiscal indicators - but rather takes into account the complete picture offered by all available and meaningful leading indicators of future inflation. In this context, the Governing Council analyses the economic reasons behind the projected risks to price stability. The appropriate monetary policy response to a threat to price stability will depend on the nature of the threat. The Governing Council can only understand the nature of the risk if it is presented with a full set of data. From these, it can attempt to identify the nature of the disturbance to price stability. Having identified the threat, an appropriate policy response can be selected and implemented.

Internal forecasts of economic activity and inflation in the euro area can also contribute to the success of an appropriately forward-looking monetary policy. However, the Eurosystem should not be judged on, or held accountable for, the accuracy of its internal forecasts. Thus, publication of the forecasts cannot contribute to accountability. Rather, its performance in maintaining price stability in the medium term should be used by the public to judge the success of the Eurosystem.

Allow me to say a few words on certain proposals made in the recent public debate, which may be deemed to suggest that the focus of monetary policy should be shifted towards objectives other than price stability. Indeed, some recent suggestions seem to imply that the Eurosystem should react more or less automatically to exchange rate movements or other specific variables such as unit labour costs.

The Eurosystem’s monetary policy stance is not one of benign neglect with respect to the exchange rate. The Eurosystem’s stability-oriented monetary policy strategy takes into account the external value of the euro as one, potentially important, determinant of the outlook for price stability. Obviously, if a strong and abrupt appreciation of the euro were to occur, this would lead, all other things being equal, to downward pressures on price developments. In such a situation, there would be a stronger reason for lowering the ECB’s interest rates, which might then, in turn, help to counteract part of the prior exchange rate movement.

However, monetary policy reactions to the exchange rate, or to any other variable, can never be mechanistic or automatic. According to its stability-oriented strategy, the Eurosystem always has to analyse carefully a wide set of indicators, the nature of any disturbances and their implications for the overall outlook for price developments in the medium term. In any case, it must be borne in mind that the Treaty on European Union also requires the single exchange rate policy to respect the primary objective of price stability. Thus, the ECB cannot commit itself in advance to any specific reaction with respect to the exchange rate.

I am sure you would agree with me that it would not necessarily be appropriate to tighten the monetary policy stance simply because the euro had depreciated, if, at the same time, we were in a recession with increasing downward pressures on prices. As such mechanistic reactions to exchange rate developments could easily endanger price stability and destabilise economic developments in the euro area, we deliberately excluded any kind of exchange rate targets or target zones from our strategy.

In line with its clear mandate enshrined in the Treaty, and for sound economic reasons, the ECB has to decide which monetary stance best serves the maintenance of price stability over the medium term and then act accordingly. At the same time, the Treaty also emphasises the need for sound fiscal policies. This clear separation of responsibilities is both efficient and transparent.

The Eurosystem is open, transparent and, above all, accountable for its performance. As part of its communication strategy, the Governing Council of the ECB regularly informs the public about changes in its assessment of the monetary, economic and financial situation in the euro area and about specific monetary policy decisions. The Governing Council meets every fortnight. The first meeting in every month is immediately followed by a press conference and the release of the President’s Introductory Statement, which is a summary of the conclusions of the Governing Council with regard to its assessment of monetary, financial and other economic developments. This is similar to what other central banks call minutes. We are convinced that this very prompt delivery of information serves the interests of the public in an optimal way. I do not think that many central banks publish their minutes only a few hours after the meeting of their governing body. I am also convinced that it is in the public interest for the view of the whole Governing Council to be presented, rather than the views of individual members. Moreover, the ECB has just published its first edition of the Monthly Bulletin, and will publish an Annual Report. We shall also explain our policies on a regular basis in speeches and interviews, also making a presentation to the European Parliament at least four times a year.

II. Recent monetary policy decisions and operations

Co-operation among European national central banks has always been close and, among participants in Stage Three, it has become increasingly so in recent years and months. The co-ordinated reduction of the key interest rates by all central banks of the euro area in December 1998 clearly demonstrated that Monetary Union had begun de facto before the start of Stage Three. This co-ordinated measure contributed to the stabilisation of market expectations.

The Governing Council of the ECB announced that the new level of the euro area-wide key interest rate of 3% would prevail “for the foreseeable future”. In other words, in the absence of further disturbances to the economy or the emergence of new and unanticipated threats to price stability, this level of interest rate is considered to be consistent with the primary objective of maintaining price stability over the medium term. Our announcement helped to resolve some uncertainty at a time when the practical, technical and logistical tasks required by the changeover weekend were uppermost in our minds and in those of market participants.

The first main refinancing operations of the Eurosystem were successfully settled. While paying due attention to the uncertainties related to the phasing-in of the new system, the decisions were taken on the basis of the liquidity conditions prevailing in the euro area money market as a whole. In addition to the refinancing operations, the Eurosystem offers standing facilities, which can be accessed by credit institutions via the NCBs. The deposit and marginal lending facilities constitute, in normal circumstances, the upper and lower bound for the overnight market interest rate.

As a transitional measure, the Governing Council of the ECB had narrowed the corridor established by the interest rates on the Eurosystem’s standing facilities from 4 January until 21 January 1999. The intention was to facilitate the necessary adjustments to the new institutional environment resulting from the transition to Stage Three.

At its last meeting, the Governing Council of the ECB confirmed its earlier assessment of the outlook for price stability. The Governing Council therefore decided that for the next two main refinancing operations the same conditions will apply as for the three main refinancing operations settled earlier this month. This means they will be fixed rate tenders conducted at an interest rate of 3.0%

Furthermore, the Governing Council confirmed that it did not see a need for continuing the application of the narrow interest rate corridor beyond the date of 21 January 1999. It was thus decided to revert to the interest rates on the Eurosystem's two standing facilities, which it had set for the start of Stage Three. It set the marginal lending rate at a level of 4.5% and the deposit rate at 2.0% with effect from 22 January 1999. This decision has to be seen against the background of the experience with the functioning of the euro area-wide money market since the beginning of the year. Difficulties of some market participants with the functioning of the area-wide money market have diminished substantially over time. As a consequence, overall, the integration of the euro area money market has therefore reached a satisfactory state only three weeks after its creation.

The first regular longer-term refinancing operation, which was conducted using parallel tenders with three different maturities of one, two and three months, was also settled successfully on 14 January 1999. It was conducted as a standard variable rate tender, using the single rate allotment procedure. In contrast to the main refinancing operations, these longer-term market operations are not aimed at signalling the Eurosystem's monetary policy stance. The ECB announces standard allotment volumes in advance. Therefore, interest rates from these operations are to be seen as indicators of market conditions.

III. Regular assessment of monetary, financial and economic conditions

Finally, I should like to report on the Governing Council's regular assessment of monetary, financial and economic conditions. We consider the current monetary trend for the euro area to be compatible with continued price stability in the euro area. The 12-month growth rate of the broad monetary aggregate M3 decreased from 5.0% in October 1998 to 4.5% in November 1998. The three-month moving average of M3 (covering the months September to November 1998) stood at 4.7%, i.e. very close to the reference value of 4½% per annum.

With respect to the broadly based outlook for price developments and risks to price stability, financial market developments may be seen as indicating a favourable assessment of the recent monetary policy decisions of the Eurosystem, signalling that financial market participants expect the environment of price stability to continue. In this connection, I could mention the fall in long-term interest rates at the start of 1999 to new historical lows and the fact that the yield curve has shifted downwards.

Indeed, conditions for investment at the start of Monetary Union are favourable. This relates, in particular, to the currently prevailing low interest rate level, which significantly reduces the costs of financing for investors. Economic growth in the euro area has become more broadly based, as is reflected in private consumption and investment.

At the present juncture, the outlook for the euro area economy is still very much influenced by the uncertainties surrounding the evolution of the world economy in 1999. These uncertainties have adversely affected indicators of industrial confidence in the euro area and have fuelled expectations of a slowdown in economic activity in the short term. In part, the deteriorating external environment, which has its origins in the Asian and Russian financial crises, places a high burden on overall growth prospects. The picture, however, is mixed. Order books and capacity utilisation point to a less optimistic outlook, while retail sales and the recent pattern in employment and unemployment suggest more favourable trends. Consumer confidence also remained high until late 1998. In general, this pattern of mixed evidence appears to characterise the economic situation in the euro area around the turn of the year, and we shall continue to monitor developments carefully.

I should also like to emphasise that the Governing Council carries out a forward-looking assessment of inflationary pressures and carefully assesses risks to price stability, whatever direction these may take. With respect to the latest data on the HICP, the annual increase for November 1998 showed a further slowdown to 0.9%, compared with 1.0% in the two previous months. This development was in line with previous trends. It was mainly due to lower annual percentage changes in the prices of food and a further reduction in energy prices. A significant contribution was also made by moderate wage increases. In combination with high overall productivity gains throughout the whole economy, a reduction in unit labour costs was reported.

On balance, the described overall economic environment and all available forecasts for 1999 do not point to significant upward or downward pressure on price developments in the short term. Nevertheless, factors contributing to risks to price stability on both sides need to be taken into account. On the one hand, downward risks relate to the global environment and potential repercussions on the euro area, for example via import prices and further pressure on producer prices. These developments will be monitored closely. On the other, unexpected upward pressure on wages and a relaxation of the fiscal stance would clearly alter the general environment. Therefore, we shall also carefully monitor the outcome of ongoing wage rounds, the plans for fiscal policy in 1999 and over the medium term, as well as the implementation of such plans in compliance with the Stability and Growth Pact.

In summary, the current situation, which is characterised by monetary growth compatible with continued price stability and the absence of immediate upward or downward pressure on price developments, justifies maintaining the current monetary policy stance, with an ECB interest rate of 3% for the main refinancing facility. Indeed, monetary policy in Stage Three started with very low interest rates by historical standards.

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