Mr Duisenberg evaluates the single European monetary policy

Speech by the President of the European Central Bank, Dr Willem F Duisenberg, at the University of Hohenheim, Germany, on 09/02/99.

Ladies and gentlemen,

The single European monetary policy has been a reality for a little more than five weeks. After years of intensive preparatory work and successful economic convergence, monetary policy is now jointly determined for a large part of Europe by the Governing Council of the European Central Bank. The monetary policy is implemented by the Eurosystem, the name given to the ECB and the 11 central banks of the EU Member States participating in Monetary Union.

The single currency is quoted on the international financial markets and is used in non-cash payments. However, the euro will not appear as yet in tangible form as banknotes and coins. Nonetheless there is no doubt that this currency, which was only brought into existence on 1 January 1999, will play an important role both within the euro area and beyond.

There is good reason for this confidence, ladies and gentlemen. Overall the first few weeks went smoothly for the single currency and the monetary policy of the Eurosystem. The start did not pass by entirely without a hitch – which was not to be expected in any case, given the significance and scale of this project – but there were no major complications.

Monetary Union is a unique and outstanding achievement. It provides the great opportunity to achieve the goal of lasting price stability throughout Europe. Price stability is the best contribution that monetary policy can make to lasting economic and employment growth in Europe. The national governments and all those involved in collective wage bargaining are being called on to remove the structural causes of the excessively high unemployment. We can only hope that the introduction of the euro will spur the implementation of structural reforms.

The stability-oriented monetary policy strategy of the Eurosystem

The Treaty establishing the European Community assigns the European System of Central Banks (ESCB) and thereby the Eurosystem the primary objective of maintaining price stability. The Governing Council will do its utmost to fulfil this task and to explain its monetary policy so as to be comprehensible to the general public. For this reason we have developed a stability-oriented monetary policy which essentially consists of three main elements.

The Governing Council has published a quantitative definition of its primary objective, price stability. This gives clear guidance for expectations in relation to future price developments. Price stability is defined as an increase in the Harmonised Index of Consumer Prices (HICP) of the euro area of less than 2% compared with the previous year. The publication of this definition provides the public and the European Parliament with a clear benchmark against which to measure the success of the single monetary policy, and thereby provides for the transparency and accountability of the Eurosystem and its policy.

The wording “less than 2%” clearly defines the upper limit for the measured inflation rate which is compatible with price stability. I do not think I need emphasise that deflation – or a sustained fall in prices – would be incompatible with price stability. The latest available data for the annual rate of inflation according to the HICP for the euro area as a whole fall within the definition of price stability. This outcome is clearly the result, above all, of the successful monetary policy of the national central banks in the years before the start of Monetary Union.

The ECB has only been responsible for monetary policy for a little more than one month. It will only be possible to judge the success of its current policy in one to two years' time. This reflects the fact that the transmission of monetary policy impulses is subject to relatively long and variable time lags. The Governing Council has therefore emphasised that price stability must be maintained in the medium term. This statement underlines not only the need for a forward-looking approach to monetary policy, but also takes into consideration the short-term volatility of prices in response to non-monetary shocks which are beyond the control of monetary policy.

In order to achieve the goal of price stability, our strategy rests, in particular, on two "pillars". Before I explain this in more detail, I should like to emphasise that traditional and previously established macroeconomic relationships could change as a consequence of the introduction of the euro. This was one key reason why neither a monetary targeting nor a direct inflation targeting strategy could be applied. Our strategy is also more than just a simple combination of these two approaches. Rather, it is precisely tailored to the needs of the ECB.

The first pillar of the monetary policy strategy is a prominent role for money. Since inflation is ultimately a monetary phenomenon in the medium term, the money supply provides a natural "nominal anchor" for a monetary policy geared to safeguarding price stability. To emphasise this prominent role, the Governing Council has published a quantitative reference value for growth in the money supply. The first reference value decided upon by the Governing Council for growth in M3 was 4.5% per annum and was published on 1 December. This value is based on the above-mentioned definition of price stability and assumes a trend growth in real gross domestic product of 2-2.5% per annum, as well as a medium-term reduction in the velocity of circulation of M3 of around 0.5-1% per annum.

We shall not, however, respond mechanistically to deviations from the reference value for money supply growth, but shall first analyse them carefully for signals relating to future price developments. Larger or sustained deviations normally signal risks to price stability.

The second pillar of the monetary policy strategy consists in a broadly based assessment of the outlook for price developments in the entire euro area. This assessment will be based on a broad range of monetary policy indicators. In particular, those variables which could contain information on future price developments will be analysed in depth. This analysis should not only provide information on the risks for price development, but should also help to identify the causes of unexpected changes in important economic variables.

Some commentators reduced this comprehensive analysis to an inflation forecast. At the same time, there were demands for the ECB to have to publish these forecasts in order to satisfy the need for transparency and accountability. Therefore allow me to make this clear: our strategy includes a comprehensive analysis of numerous indicators and several forecasts. To focus on a single official inflation forecast of the Eurosystem for a specific point in time would in no way accurately reflect our internal analytical and decision-making process. It would impinge upon the transparency and clarity of the explanation of our policy. The publication of an official inflation forecast would also be inappropriate with regard to the accountability of the ECB, all the more so if this forecast were based on the assumption of no change in the monetary policy. The success of the monetary policy of the ECB should primarily be measured in terms of the maintenance of price stability, not the accuracy of its conditional forecasts.

The stability-oriented monetary policy strategy of the Eurosystem, which I have just outlined, constitutes a new and clear strategy. It emphasises the primacy of the goal of price stability. It takes into account the inevitable uncertainties concerning economic relationships inherent in the transition to Monetary Union and the associated systemic changes and guarantees a high degree of transparency.

Ladies and gentlemen,

Allow me to comment on certain suggestions on the orientation of monetary policy which have recently appeared in the press. Some of these ideas give the impression that monetary policy should concentrate upon objectives other than price stability, since stable prices have already been achieved. Inter alia, it has been suggested that the ECB should react more or less mechanistically to exchange rate developments or other variables such as unit labour costs. Furthermore, there were calls for monetary policy, by means of reductions in interest rates, to be used to combat unemployment. Against this background there is a need to set out clearly the possibilities and limitations of monetary policy.

Both the reasoning in the Maastricht Treaty and many economic analyses show that the best contribution the single monetary policy can make to employment growth is to concentrate on price stability. Without such a clear approach there is a danger that the public may question the commitment of the Eurosystem to the goal of maintaining price stability. Inflation expectations, risk premia and thus long-term rates would rise. This would increase the cost of the investment which is necessary for a sustained and lasting rise in the standard of living.

Even under the best possible circumstances, though – i.e. if it proves to be possible to assure lasting price stability – monetary policy alone cannot solve the major economic problems of unemployment and future problems in social security systems.

The Governing Council regards the current high level of unemployment in the euro area as a matter of great concern. This problem is, however, predominantly a structural one. It is mainly the result of the rigidities in the labour and goods markets in the euro area which have arisen partly through an excessive and disproportionate degree of regulation. Structural economic reforms, which target the reduction of rigidities, are the appropriate solution. In those euro area countries in which such reforms have been implemented unemployment figures have declined markedly. In addition, I should like to emphasise that moderate wage developments and a reduction in the burden of tax and social security contributions would generally help to reduce unemployment. This would be the case even if the country concerned did not trade heavily with its neighbouring countries. The positive influence of low taxes and wages on employment clearly has overall benefits from an international perspective. Such a policy should not be denounced as “wage dumping”.

Turning to the role of exchange rates between the euro and other important currencies outside the EU, in particular the US dollar, the Eurosystem has, in formulating its monetary policy strategy, made an unambiguous choice. This strategy clearly rules out explicit or implicit objectives or target zones for the euro exchange rate. The pursuit of an exchange rate objective could easily jeopardise the maintenance of the objective of price stability and could thereby also be detrimental to real economic development. Target zones for exchange rates could, for example, lead to the ECB having to raise interest rates in a recession, despite increasing downward pressure on prices. I am sure you will agree that such a mechanistic response to a change in the euro exchange rate would not be optimal. Furthermore, it is important to remember that we are living in a world with high capital mobility. Exchange rate agreements, which might have been possible to implement until recently, are no longer feasible.

The lack of an exchange rate target does not mean that the ECB is totally indifferent to or takes no account of the euro exchange rate. On the contrary, the exchange rate will be observed and analysed as a potentially important monetary policy indicator in the context of the broadly based assessment of the outlook for price developments. A stability-oriented monetary and fiscal policy, as stipulated by the Maastricht Treaty and the Stability and Growth Pact, is an essential pre-condition for a stable euro exchange rate. Of course, there is no guarantee of lasting exchange rate stability, not even in a fixed exchange rate regime. Exchange rate fluctuations are often caused by structural or fiscal policy, asymmetric real shocks or conjunctural differences. Monetary policy would clearly be overburdened if it had to prevent such movements in the exchange rate.

We cannot and shall not gear our monetary policy towards a single variable, whether a money supply aggregate, an index, the exchange rate or an inflation forecast for a particular point in time. Nor can we be involved in any ex ante co-ordination which would entail an obligation to react to particular commitments or plans. The ECB will always carefully analyse all relevant indicators. In this context, it is particularly important that the economic causes of potential risks to price stability in the euro area are understood as fully as possible. Appropriate monetary policy decisions also depend upon the causes of unexpected changes in important economic variables. The Governing Council must, for example, take a view on whether changes in important indicators are of a temporary or permanent nature, and whether a demand or supply shock is involved. In our deliberations we also attempt to take into account how the financial markets, consumers and firms are expected to react to monetary policy decisions. I believe few would contest that such a complex analysis cannot meaningfully be reduced to a more or less mechanistic reaction to a few variables or a single official forecast.

In addition, concern was often expressed that the Eurosystem would not act transparently enough. In this context, it was said that a transparent monetary policy also necessitated the publication of the minutes of the meetings of the Governing Council and disclosure of the voting behaviour of the individual members of the Council.

For sound reasons the Governing Council decided not to adopt this approach. The publication of individual positions could easily lead to national influence being exerted over the individual Council members. The members of the Governing Council must not, however, be seen as national representatives. They decide together on the monetary policy for the euro area as a whole. The Governing Council has committed itself to go beyond the reporting and explanatory requirements laid down in the Treaty, which are among the most comprehensive requirements by international standards.

On the basis of our strategy, after every first meeting in the month I deliver to the press a detailed explanation of our assessment of the overall economic situation and, in particular, the outlook for price stability. The content of this so-called “introductory statement” is very close to what other central banks refer to as minutes. In this way, the public receives comprehensive information immediately following the meetings of the Governing Council. In addition, each month we shall publish a detailed report on the economic situation and monetary policy throughout the euro area in our Bulletin. Such rapid information on the results of the meetings of the Governing Council and the current economic analysis of the ECB without doubt demonstrates a high degree of openness and transparency.

The most recent monetary policy decisions and operations

Co-operation between the European central banks was always very close. In the last few months of 1998 the countries participating in the third stage of Monetary Union co-operated more and more closely. The co-ordinated reduction in leading rates at the beginning of December 1998 clearly showed that the currency union had begun de facto before the start of Stage Three. This co-ordinated measure contributed substantially – as we now know – to the stabilisation of market expectations.

For more than five weeks the ECB has been conducting monetary policy operations, mainly in the form of reverse open market operations. The main operation will be carried out at a weekly frequency with a maturity of two weeks. So far, five such operations have been conducted successfully, at a fixed interest rate of 3%.

Besides the reverse transactions which constitute the main instrument for liquidity control and targeting interest rates, the Eurosystem offers two “standing” facilities: the marginal lending facility and the deposit facility. These can be accessed by credit institutions via the national central banks. The marginal lending facility is primarily a safety valve for short-term liquidity shortages in the banking system and thereby limits upward movements in money market rates. To some extent, its counterpart is the short-term deposit facility, which is used to absorb short-term liquidity surpluses. This forms the lower limit for money market rates. For the start of Monetary Union the interest rate on the deposit facility was set at 2% and the rate on the marginal lending facility was set at 4.5%.

As a transitional measure, the Governing Council decided to establish a narrow corridor of 2.75-3.25% between the rates on the marginal lending facility and the deposit facility from 4 to 21 January 1999. The intention was to facilitate the necessary adjustment to the new institutional environment brought about by the transition to Stage Three. As already announced, on 21 January 1999 it was decided to return to the rates on the two “standing” facilities that were set for the start of the single monetary policy. Since 22 January 1999, therefore, the rate on the deposit facility has been 2% and the rate on the marginal lending facility has been 4.5%.

A critical factor in this decision was the behaviour of the money market for the euro area as a whole since the beginning of the year. The Governing Council established that over time there had been a marked reduction in the difficulties experienced by some market participants with the introduction of the integrated money market and, in particular, with cross-border liquidity flows. All in all, the integration of the money market in the euro area reached a satisfactory stage only three weeks after its implementation. In analysing the money market it should be noted that, inter alia, there can be a marked difference between ECB interest rates and short-term market rates. On the one hand, market rates may include credit risk premia and, on the other, expectations may lead to differences between the two rates.

At its meeting last Thursday the Governing Council confirmed its earlier assessment of the outlook for price stability. Therefore it was decided to leave the conditions for the next main refinancing operations, on 10 and 17 February 1999, unchanged. They will be carried out as volume tenders at a fixed rate of 3%, the same conditions as for the last such monetary policy operations.

In addition, in recent weeks the first longer-term open market operations were conducted, in the form of reverse transactions. These were carried out on 14 January 1999 in three parallel tender procedures with maturities of one, two and three months. The fixed rate tender procedure was used. By contrast with the regular main refinancing operations, the Eurosystem does not use these longer-term operations to send signals to the market and therefore usually acts as a price-taker. The ECB thus gives advance indication of the planned allocation. The interest rates which arise from these monetary policy operations should therefore be seen as indicators of prevailing market conditions.

Regular assessment of the monetary, financial and economic situation

To conclude, I should like briefly to report on the Governing Council's current assessment of the monetary, financial and economic situation. On the basis of these assessments the Governing Council decided last Tuesday to leave interest rates unchanged.

Taking into account the latest monetary data for December 1998, the three-month moving average of the 12-month growth rate of the monetary aggregate M3 (for the period from October to December 1998) remained more or less stable at 4.7%. This value is very close to the reference value set by the Governing Council. According to our analysis, the evolution of the money supply shows no risks to price stability. Credit to the private sector also grew strongly in December last year. Although at present we do not perceive any inflationary signals, further developments will be very carefully monitored.

With regard to the broadly based assessment of the outlook for price developments and the risks to price stability in the euro area, monetary and financial developments can be seen to indicate a favourable assessment of the latest monetary policy decisions of the Eurosystem. They indicate that market participants expect a continuation of the environment of price stability. Long-term rates fell to new historical lows at the beginning of 1999 and there was an overall downward shift in the yield curve. Therefore, financing conditions for investment are currently exceptionally favourable.

At present the growth prospects for the euro area are, however, still marked by the uncertainties relating to the development of the world economy in 1999. These uncertainties have had a negative impact on indicators of the economic climate in the euro area. There are widespread expectations of an economic slowdown in the near future. This deterioration in the external economic environment can be linked, above all, to the financial crises in Asia, Russia and Latin America. However, there is a mixed picture. While the growth rate for industrial production fell up to November 1998, retail sales figures and consumer confidence have recently shown positive trends. Furthermore, growth in real gross domestic product in the euro area was relatively robust in the third quarter of 1998. In the United States real growth in the fourth quarter actually turned out higher than expected. Measured against the HICP, consumer prices in the euro area rose by 0.8% in December 1998. This is a tenth of a percentage point lower than in November. This development is in line with earlier trends. It can be linked, in particular, to a further decline in energy prices and a weakening in price increases in industrial goods.

All in all, the above-mentioned economic development and the available forecasts for 1999 do not indicate any noticeable upward or downward pressure on prices. Potential upward risks could arise from a change in the external global economic situation and any associated effects on the euro area, via import and producer prices. These developments must be carefully monitored. There is concern that inflationary pressure might develop in the event of a strong increase in wage prices and an easing of fiscal policy. Developments in the exchange rate will also be closely monitored in view of their significance for price developments.

Finally, let me emphasise that the current level of real interest rates is exceptionally low. If real interest rates are taken simply as the difference between nominal rates and the current increase in consumer prices (HICP), short-term real interest rates in January 1999 stood at 2.3%, i.e. around 80 basis points lower than one year ago. Long-term real rates have fallen even more, by 110 basis points, and stood at 3% in January. These levels are very low, compared both with other countries and with historical data. In line with the safeguarding of price stability, the current monetary and financial conditions thus clearly support future economic growth. Monetary policy can do no more than this without jeopardising the great overall economic advantages of price stability and its own credibility.

Real structural reforms which increase the flexibility of the labour markets, as well as a continuation of the moderate increase in wage prices, would not only ease the burden on monetary policy but would also support employment growth. This will be all the more true if the deterioration in the economic situation this year is worse than expected owing to the negative aspects of the external economic environment.