Mr Duisenberg discusses the Eurosystem's strategy for the euro

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at a conference organised by "The Economist" in Rome on 12 March 1999.

I should like to start by thanking you for the invitation to speak here on the occasion of this conference. It is only a little more than two months since the euro was launched. Today I should like to discuss the main challenges for monetary policy at the start of Monetary Union. Clearly, keeping the internal value of the euro stable is the overriding task ahead of us. With this in mind I shall begin by broadly outlining the objectives and main elements of the monetary policy strategy of the Eurosystem. I shall then turn my attention to the role that can be played by fiscal policy and structural reforms in supporting the stability of the euro and reducing unemployment. Finally, I should like to say a few words about the distribution of responsibilities at different levels of economic policy-making with a view to maintaining stability and growth in the euro area.

Monetary policy: objectives and strategy

Let me turn to the monetary policy strategy of the Eurosystem. The Treaty establishing the European Community assigns the European System of Central Banks (ESCB) the primary objective of maintaining price stability in the euro area. In order to guide expectations of future price developments and to facilitate the public's assessment of the success of the single monetary policy, the Governing Council of the European Central Bank (ECB) has announced a quantitative definition of its primary objective. This clarifies how the Treaty's mandate is interpreted by the Eurosystem, that is, by the ECB and the 11 participating national central banks (NCBs).

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%. Price stability is to be maintained over the medium term. According to the most recent available data, the annual rate of inflation of 0.8%, measured on this harmonised basis, is consistent with this definition of price stability.

The Treaty states that the ESCB shall support the general economic policies in the European Community only if it can do so without prejudice to the objective of price stability. The logic of the Treaty seems clear. It is acknowledged that the best contribution monetary policy can make to high employment and economic growth is to maintain price stability. In this context, it is difficult to see how certain proposals made in the ongoing public debate, which might suggest that the focus of monetary policy should be shifted towards short-term growth or employment objectives, can be fulfilled without violating the primary objective of maintaining price stability, thus ultimately producing an overall deterioration in prospects for economic growth and employment.

Monetary policy needs a forward-looking, medium-term orientation. It would be overambitious and therefore risky to steer the economy in the short term. Fine-tuning would more likely lead to instability than stability. A medium-term orientation takes into account the fact that monetary policy affects the price level only with variable, usually long and unpredictable time lags. For example, a large proportion of the substantial reduction in interest rates during the second half of last year will still have an impact on the euro area economy. 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. It ensures as much continuity as possible with the strategies previously pursued by the NCBs. At the same time, it gives due consideration to the unique situation which will prevail in the early years of Monetary Union. This strategy rests on two "pillars": a prominent role for money as expressed by the announcement of a reference value for the annual growth of M3 and a broadly based assessment of the outlook for price developments, and the risks to price stability in the euro area as a whole.

Monetary developments can provide useful information about future price developments and thereby act as an important compass for the conduct of monetary policy. There is broad consensus that, in the medium to long term, the development of the price level is a monetary phenomenon. Consequently, the Governing Council of the ECB has announced a quantitative reference value for M3 growth, which has been set at an annual rate of 4½%. Under normal circumstances, substantial deviations from the reference value would tend to indicate future risks to price stability. However, 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 send about the prospects for price developments. If this analysis 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 clearly not constitute a complete summary of all the economic information necessary to enable appropriate policy decisions to be taken. 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.

This broadly based assessment takes into account, inter alia, the information content of wage developments, exchange rates, fiscal indicators, real activity, assets and commodity prices. Internal forecasts of economic activity and prices in the euro area can also contribute to the success of an appropriately forward-looking monetary policy. Monitoring monetary, financial and economic developments also helps to identify the nature of shocks hitting the economy. It thereby contributes to the assessment of overall economic developments. On the basis of this thorough analysis, the interest rate will be set in a way that best serves the maintenance of price stability.

The contribution of fiscal policy to a stable euro

With regard to fiscal policies, I should like to stress the following main points of interest with regard to a stable euro:

- A sound conduct of fiscal policies is important for the stability of the euro.

- In particular, strict implementation of the Stability and Growth Pact by each Member State is vital.

- The targets envisaged in the current stability programmes to bring down government deficits and debt levels represent a minimum requirement for most Member States rather than a final aim.

Budgetary positions in the euro area as a whole have not yet been consolidated sufficiently. Government debt as a percentage of GDP remains far too high on average and has only started declining hesitantly in the recent past. Deficit-to-GDP ratios in a number of countries are still closer to the 3% value set in the Treaty as a reference for excessive deficits than to the medium-term balanced or surplus position envisaged in the Stability and Growth Pact. In case of a prolonged growth slowdown we might therefore easily see deficits reaching excessive levels. In addition, deficits fell very slowly in 1998, this reduction in fiscal imbalances being the result of strong economic growth and falling interest payments rather than of genuine fiscal consolidation measures. Structural and primary balances have even deteriorated. In addition, the progress in structural fiscal consolidation envisaged for the medium term appears to be only moderate.

Why should monetary policy-makers be bothered by such unbalanced budgetary positions? Institutional arrangements for Monetary Union and the Eurosystem have been fully and specifically developed so as to prevent any direct link between an increase in public sector deficits and a monetary expansion, and thereby inflation. This is ensured by (a) assigning to the Eurosystem the primary objective of price stability, (b) banning the direct financing of government deficits by central banks, and (c) precluding any influence by governments or other institutions on monetary policy decisions. However, even in this setting, the conduct of fiscal policies has a clear bearing on the objective of price stability. In particular, doubts about the soundness of fiscal policy can influence the effectiveness of monetary policy instruments and can undermine the credibility of monetary policy.

For decades – and until very recently – fiscal policies have followed a trend of ever-growing public sector and government debt levels. In Monetary Union, without binding fiscal rules, countries might have even less incentive to pursue prudent fiscal policies. The main reasons are, first, that risk premia offsetting inflation and exchange rate expectations disappear on a country-specific basis and may not be fully outweighed by default risk premia, and, second, that in Monetary Union fiscal consolidation and its effects on financial stability partly take on the role of a public good, the benefits of which in terms of lower interest rates can be enjoyed by individual countries even if they have not contributed to its supply. Hence, the Treaty establishing the European Community contains, for good reasons, a number of provisions on the conduct of fiscal policies, which have been further clarified by the Stability and Growth Pact. However, I must admit that the current position with regard to the implementation of these provisions in the stability programmes submitted to the European Commission by a number of Member States is less than fully satisfactory.

The centrepiece of the budgetary provisions to be respected by Member States is the medium-term objective of a budgetary position close to balance or in surplus. Safeguarding sound government finances is a means of reinforcing the conditions for price stability and of promoting strong sustainable growth which is conducive to employment creation. In addition, by achieving at least balanced budgets in normal periods of the cycle, governments would create a sufficient safety margin to allow full operation of automatic stabilisers in the event of a slowdown in growth without inflating deficits to excessive levels. In the euro area as a whole we are still far from reaching this target. Substantial structural imbalances continue to restrict the flexibility of public sector budgets. Any significant increase in overall deficits – for instance, as a response to a decline in real GDP growth rates – could reverse the limited progress we have seen in recent years in reducing debt ratios across the euro area. This would imply the risk of initiating detrimental debt dynamics. Hence, governments could contribute most effectively to supporting stability and growth in the euro area by regaining sufficient flexibility in their budgets as soon as possible. However, despite the desirability of achieving this room for manoeuvre swiftly, a number of stability programmes only aim to attain this flexibility at a relatively late date and on the assumption that economic growth will be sustained and interest rates low.

Apart from showing slow progress in restoring budgetary flexibility for the purposes of automatic stabilisation, governments have paid insufficient attention to other considerations that are also of major importance in setting the appropriate medium-term objectives which respect the requirements of the Stability and Growth Pact. This is the case with regard to the need to ensure a rapid decline in high debt ratios and the need to cater for the costs associated with the ageing of the population. In particular, additional budgetary room for manoeuvre will soon be required in order to address the substantial financial consequences of ageing populations. According to long-term projections and estimates, current trends in birth rates and life expectancy, together with unfunded public pension and health care schemes, result in very high implicit government liabilities in most euro area countries. In many cases these implicit liabilities appear to be far in excess of official government debt levels. Preventing these financial burdens from being shifted onto future generations of taxpayers and thereby safeguarding sound government finances would require substantial surpluses to be built up over the medium term.

The contribution to lower unemployment made by structural reforms of the labour markets

I now turn my attention to the contribution that structural reforms, particularly of euro area labour markets, can play in reducing unemployment and in supporting the stability of the euro. The high level of European unemployment is quite rightly a source of deep concern. It is of the utmost importance to implement policies than can bring about a lasting reduction in unemployment. Clearly, the approaches that are most likely to have a lasting effect are those that address the root cause of the problem, not just the symptoms. The root causes of high unemployment in the European Union are structural rigidities in the labour market as well as tax and public transfer policies. This view is supported by a wide body of academic literature and was also a key finding of the OECD Jobs Study. It is obvious that structural problems require structural solutions. Implementing an inflationary monetary policy will not make lasting reductions in unemployment, but will actually serve to exacerbate the problem over the medium term. As we know, inflation distorts saving and investment decisions, raises the risk premium in long-term interest rates and undermines the allocative efficiency of the price mechanism. In addition, it is particularly detrimental from the perspective of social justice.

The underlying structural nature of the European unemployment problem can be seen most strikingly if one compares developments in Europe with those in the United States over the last three decades. In 1970 the unemployment rate in the United States, at around 4%, was at least twice as large as that prevailing in most European economies. Since 1970 there has been significant cyclical variation in the unemployment rate in the United States but no upward trend. At 4.4% in January 1999, the unemployment rate in the United States is almost the same as it was in 1970. In contrast, average European unemployment appears to have risen with each passing economic cycle. By the early 1980s the unemployment rates in the United States and Europe had broadly converged. Since then the unemployment rate in the United States has been below the average for the European Union. Despite recording a measure of decline last year, the euro area unemployment rate remained at 10.8% in December, more than double the corresponding rate in the United States. However, some European countries, particularly those with more flexible labour markets, have managed to avoid the trend of ever-rising unemployment. For example, the Netherlands, Ireland, Portugal, Austria and Luxembourg at present have unemployment rates well below the euro area average.

If one examines the duration of unemployment, it is immediately apparent that Europe's problem is principally one of long-term unemployment. According to OECD figures, around half of the unemployed of the European Union have been out of work for at least a year, while in the United States under 10% of the unemployed have been without work for this long. This suggests that in Europe there is an urgent need to improve incentives aimed at getting the long-term unemployed back to work. It also suggests that there is little scope for a stimulus to increase demand, but rather that structural measures should be implemented.

It has been suggested that the Eurosystem focuses too exclusively on supply, almost forgetting demand. This is a misunderstanding. The truth is this, and I repeat: we are convinced that a lasting cure for European unemployment can only be found by applying measures affecting supply. It is not true, however, that our monetary policy strategy neglects the demand side of the economy. On the contrary, our monetary policy takes into account all monetary and economic developments, including demand shocks, when decisions are taken on the monetary stance which best serves the maintenance of price stability. One might rightly argue that in this way we do not actively respond to short-term changes in GDP. There is a good reason for this: it would be overambitious. We cannot steer demand precisely, especially in the short term. Therefore, we focus on creating the appropriate conditions for non-inflationary growth of demand in the medium term. With money supply growing at almost 5% and with real interest rates well below historical averages, monetary policy is delivering in practice what I have just explained in theory. It goes without saying that we will continue to monitor all developments to determine the appropriate policy stance in the meetings of the Governing Council.

There are many good examples of what can be done – and is currently being done in some euro area countries – in terms of structural reforms. First, there are "active labour market measures" which provide programmes of education, training and work experience targeted at the long-term unemployed; second, reforms to the tax and benefit systems which ensure that people are significantly better off in work than out of it; and third, there are measures to ensure that low-productivity workers are not forced out of the labour market. To this end, the burden of taxes and non-wage labour costs could be reduced for low-paid workers. In addition, minimum wage schemes and wage agreements reached by collective bargaining need to take account of the need to preserve jobs for low-productivity workers by reducing labour costs.

The need for structural reform of the European labour markets is widely recognised and some progress is already being made. At the meeting of the European Council held in Luxembourg in November 1997 it was decided to adopt "guidelines for employment" at the EU level every year. Each Member State has undertaken to draw up a national action plan for employment based on these EU guidelines. Although of themselves guidelines will not reduce unemployment, if one looks at the national action plans for 1998 one can find many good examples of policy measures that are aimed at increasing labour market flexibility. However, progress appears rather slow and uneven across Europe and it is important that we redouble our efforts in this area.

I recognise that structural reforms are not always easy to implement. The benefits are often enjoyed in the medium term, while short-term costs for some groups may mean that reforms are vigorously opposed by interest groups. Although there is a common objective of reducing unemployment, there is no common programme of reforms that will work in all countries. While it is possible to learn from the experience of others, each Member State will wish to develop workable policies that reflect its own particular circumstances. Although the path of structural reform is not always an easy one, it is the only way in which we can achieve the lasting reductions in unemployment that are so urgently required. I should wish to add that, contrary to competitive devaluations, such reforms, as well as wage moderation, are no zero-sum game. They contribute to net increases in average employment in an international perspective. They should thus not be criticised as "wage or social dumping".

Monetary policy and other policy areas

In line with its clear mandate enshrined in the Treaty establishing the European Community, 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. It takes account of the substantial empirical evidence and practical experience, according to which monetary policy makes its best possible contribution to the achievement of other goals by focusing on the primary objective of maintaining price stability over the medium term. This clear division of responsibilities is a sound basis for the exchange of views and information about monetary, financial and economic matters between various political authorities in the euro area and the Eurosystem.

The Eurosystem's monetary policy strategy does not foresee any mechanistic reaction to specific variables, indices or forecasts. This also applies to fiscal developments, regardless of whether they are actual, planned or promised. Clearly, we will always have to analyse thoroughly whether fiscal developments have any impact on the outlook for price stability. However, as already emphasised, we will also assess the information provided by the broad monetary aggregate and all other indicators relevant for price stability.

The clear distribution of responsibilities between monetary and government authorities enhances the credibility of monetary and economic policies in Europe. The "policy mix" resulting from monetary and fiscal policies will be an outcome of these policies rather than our initial objective. This assignment of responsibilities increases transparency and facilitates accountability. Under normal circumstances the joint interaction of all policies would be optimal provided that the basic allocation of instruments and objectives is respected and that policy-makers focus on their main objective. The Eurosystem is always ready to engage in an open exchange of views and information with policy-makers. Moreover, the public and governments are kept well informed about the ECB's objective and strategy.

Monetary policy alone – however well designed and implemented – cannot solve Europe's economic problems. National fiscal authorities can make a significant contribution to the establishment of favourable conditions for sustained economic growth and high employment in the medium to long term by conducting sound budgetary policies. Appropriate structural reforms implemented by national governments that improve the flexibility and efficiency of labour and goods markets are of utmost importance. An increase in the flexibility of labour and goods markets would certainly also help to lessen the impact of shocks, regardless of their nature. 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.

If policy-makers take their responsibilities seriously and respect the assignment of instruments and objectives as laid down in the Treaty establishing the European Community, this will be the best contribution that they can make to establishing a solid foundation for sustained stability and growth in the euro area.