Mr Duisenberg focuses on maintaining price stability in the euro area

Speech by Mr Willem Duisenberg, President of the European Central Bank, at the Swiss Banking Congress in Zurich on 10 September 1999.

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Ladies and gentlemen,

I was only too pleased to accept your invitation to this place of price stability between Lake Constance and the Dufourspitze, to report to you on the first experiences with the euro. No other country in Europe can rival the success of Switzerland in combating inflation, and this is something of which you can be very proud.

With the introduction of the single currency in Europe, European integration has scaled new heights. Since the beginning of this year, the Governing Council of the ECB has been responsible for the stability of the euro. Monetary Union means that for the whole of the euro area there is only one single monetary policy. The aim of this policy is to achieve price stability in the euro area as a whole. This means that there can no longer be a monetary policy designed to meet the needs of individual Member States. Therefore, it will be more important than ever for individual Member States to push on determinedly with fiscal consolidation and to carry out structural reforms with the aim of enhancing the flexibility of the commodity and employment markets and improving the incentives for the creation and taking-up of employment.

The Governing Council of the ECB determines the single monetary policy centrally. The Governing Council consists of the Executive Board of the ECB and the governors of the central banks in the euro area. Monetary policy decisions are implemented by the Eurosystem, which comprises the ECB and the national central banks of the 11 participating EU Member States. The national central banks are, above all, entrusted with the decentralised implementation of the single monetary policy and the relevant activities in their countries.

First, I should like to say that the launch and the first few months of the common currency have, in our view, gone well. The initial experiences with the euro and the single monetary policy have proved to be both positive and encouraging. We have currently achieved price stability and the prospects look good for this to remain the case in the years to come.

The Governing Council of the ECB has become a truly supranational body. The members of the Governing Council clearly see themselves as committed to this joint cause. They take the whole euro area into consideration when discussing and taking decisions on monetary policy.

The efforts made prior to and at the time of the changeover weekend at the beginning of this year are already part of history. Since the beginning of this year the euro has been quoted on the international financial markets and used for cashless payments. Although the euro will only become available in the tangible form of banknotes and coins in over two years' time, there is already a feeling that the euro is accepted by the majority of the population and that the benefits of the euro are appreciated. The euro, as you in Switzerland are particularly well placed to observe, is playing an increasingly important role not only within the euro area, but also beyond it.

Monetary policy with a view to price stability

European Economic and Monetary Union is a great opportunity to achieve the objective of sustained and widespread price stability in Europe. Monetary stability is the best contribution that monetary policy can make to lasting economic and employment growth. Stable prices promote the efficient allocation of scarce resources and also help to guide expectations.

For these sound reasons, the Treaty establishing the European Community specifies the maintenance of price stability as the primary objective of the European System of Central Banks (ESCB) and therefore of the Eurosystem.

The Governing Council of the ECB does its utmost to fulfil this function. In this respect, it endeavours to communicate its monetary policy to the public in a comprehensible manner. In particular, the Governing Council of the ECB has published a quantitative definition of its primary objective of price stability. This helps provide economic agents with clear guidance on expectations of future price developments. The publication of this definition also provides the public and the European Parliament with clear criteria for assessing the success of the single monetary policy, thereby rendering the Eurosystem and its policy both transparent and accountable.

The Eurosystem defines price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% to be maintained over the medium term. The wording "below 2%" clearly delineates the upper boundary for the measured rate of inflation that is consistent with price stability. At the same time, in this context, the use of the word "increase" implies that deflation – i.e. a prolonged decline in the price level – is not consistent with price stability.

The price stability objective must be achieved both in the medium term and the long term. On the one hand, this objective has been set in order to take into account the variable and somewhat unpredictable time lags affecting monetary policy. On the other, it is a reflection of the possible emergence of short-term volatility in prices resulting from non-monetary shocks that cannot be controlled by monetary policy.

Stability-oriented monetary policy strategy of the Eurosystem

The monetary policy strategy of the Eurosystem is geared towards price stability within the euro area and can basically be described as a two-pillar strategy.

The first pillar assigns a prominent role to money as defined by the broad monetary aggregate M3. There is wide consensus that medium-term inflation is actually a monetary phenomenon. Therefore, the money supply provides a natural "nominal anchor" for a monetary policy aiming at the safeguarding of price stability. To emphasise the prominent role assigned to money, the Governing Council of the ECB has announced a quantitative reference value for monetary growth in terms of the broad definition of M3.

The second pillar of the monetary policy strategy is founded on a broadly based assessment of the outlook for price developments in the euro area as a whole. This assessment is made using a wide range of indicators. In particular, those variables which may provide information on future price developments are thoroughly analysed. These analyses should not only provide information on the risks for price developments but should also help to determine the cause of unexpected changes in important economic variables.

In view of this policy stance and the published definition of price stability, the monetary policy strategy of the Eurosystem bears some resemblance to that of the Swiss National Bank. Allow me to quote the President of the Swiss National Bank who outlined the strategy of the Swiss National Bank as follows: "We try to meet the price stability objective by following developments in the monetary aggregates, but also, at the same time, taking into account other indicators." [See the paper by Hans Meyer entitled "Zur Geldpolitik im neuen Jahr", from the seminar held on 21 January 1999 at the University of St. Gallen.]

However, the motives for developing these respective strategies were different. Whilst in Switzerland disturbances affecting, in particular, the demand for central bank money "for reasons still unknown" have increased in recent years, the ECB faces additional uncertainties at the beginning of Monetary Union in terms of the effects of the shift of regime to a single monetary policy in Europe. It is difficult to assess whether conventional and reliable macroeconomic relationships are changing as a result of the introduction of the euro. In view of these uncertainties, but also in general, it is unwise to rely on a few indicators or only one when making monetary policy decisions. Indeed, to date our studies have revealed that the M3 monetary aggregate shows clear signs of stability and healthy indicator properties. This provides a sound basis for the prominent role given to the M3 monetary aggregate.

Monetary policy instruments and the operational framework of the Eurosystem

The operational framework of the Eurosystem has proved to be an effective instrument for steering money market interest rates and for limiting fluctuations. The Eurosystem controls money market interest rates by means of either the provision or withdrawal of liquidity in the banking system. Open market operations play an important role in the context of monetary policy strategy. The weekly main refinancing operations give an indication of the Eurosystem's monetary policy and provide the largest share of liquidity. Longer-term refinancing operations provide the banking system with longer-term liquidity (three months). The system of (interest-bearing) minimum reserves has contributed towards smoothing out daily liquidity fluctuations in the money market, whilst the "standing facilities" effectively limit fluctuations in the money market interest rate.

The efficiency of this set of instruments can be demonstrated by the fact that the Eurosystem has been able to manage to date without having recourse to any fine-tuning operations in the money market. In fact, developments in short-term money market interest rates have thus far been exceptionally stable and money market rates have been relatively close to the interest rates at which the ECB has provided liquidity through its weekly main refinancing operations. This is a notable success, as is the extremely rapid integration of the money markets in the euro area, in which, since January, temporary interest rate differentials have been rapidly eliminated during the day through arbitrage by active market participants.

Initial monetary policy decisions

Conditions at the start of the introduction of the euro were favourable, given a rate of inflation of below 2% (measured by the Harmonised Index of Consumer Prices) and moderate monetary growth rates in the two years leading up to the beginning of Monetary Union. However, the outlook in the euro area became increasingly gloomy in the second half of 1998 as a result of the crises in Asia and in Russia, thereby causing inflationary pressure to weaken further. The central banks of the participating countries reacted by reducing short-term interest rates. This caused the average interest rate level in those countries of the future euro area to be lowered considerably before the beginning of Monetary Union.

The close cooperation which had always existed between the European central banks was increasingly stepped up in the final months of 1998 between those countries participating in Stage Three of Monetary Union. The coordinated reduction of central bank rates in December 1998 to 3% made it perfectly clear that, de facto, Monetary Union had already begun before the start of Stage Three.

Looking at economic developments, in the first few months of this year there have been an increasing number of indications that the negative effects of the crises in Asia and Russia on growth and employment in the euro area could be more serious than was first expected. With the apparent slowdown in economic growth in the euro area, the risks that the 2% threshold for the tolerable rate of inflation would be exceeded in the foreseeable future evaporated. This forecast was also reflected in the revisions to the inflation forecasts of international organisations.

At the beginning of April 1999, the Governing Council of the ECB therefore decided to reduce the interest rates on the main refinancing operations by 50 basis points to 2.5%, as well as the rates on the standing facilities to 1.5% and 3.5% respectively. The M3 monetary aggregate did expand such that it was slightly above the reference value at the beginning of 1999. However, it was not clear, at that point in time, whether this sharp increase at the beginning of the year was a one-off effect in connection with the launch of the single currency and thus quickly fall again. In view of these uncertainties, the Governing Council of the ECB saw nothing in the development of M3 in the spring of this year to prevent it from reducing the interest rates.

Current assessment of the monetary, financial and economic situation

Please allow me to explain briefly how the Governing Council of the ECB currently views the monetary, financial and economic situation in the euro area.

Since the beginning of the year, the annual inflation rate for the Harmonised Index of Consumer Prices has stood at around 1% in the euro area as a whole, i.e. within our definition of price stability. Whilst the rate of price increases in food products has been falling since the beginning of the year, energy prices have increased strongly as result of the sharp increase in oil prices over the last few months. Overall the upward pressure turned out to be moderate, and perhaps more moderate than expected, which is a reflection of the increased competition in the service sector and the success of deregulation in some markets. However, since production costs could also increase in time as a result of the increase in energy prices, the increase in oil prices contributes to certain risks to price stability. However, this should not lead to sustained higher inflation rates, as long as the unions do not use the higher energy prices as grounds to demand additional wage increases.

The monetary aggregate M3 rose in July by 5.6% compared with 5.3% in June. The money supply figures have recently been revised upwards and we still need to examine the factors responsible for these revisions carefully. Measured by the moving average over the last three months, i.e. May, June, and July, M3 growth has moved further away from the reference value of 4.5% announced by the Governing Council of the ECB at the beginning of this year to 5.4%. This increase is largely attributable to the low opportunity costs of holding money. However, the gradual improvement in the economic outlook has probably also played a role. Similarly, the development in lending to the private sector is not restrictive at present. Annualised growth rates of just over 10% do not, in any case, indicate that the conditions for lending are currently unfavourable.

As previously explained, the money supply development of M3 plays a prominent role in our strategy. However, short-term fluctuations in the money supply should be viewed cautiously, not least because of the uncertainties associated with the brief existence of Monetary Union and the recent statistical revisions to the money supply figures. However, the most recent figures suggest increased growth.

At the same time, the prospects for an economic recovery in Europe starting this year and continuing into next year have clearly improved in the meantime. In addition to encouraging trends in the global economy, the stabilisation of output growth in the euro area has contributed significantly to this. However, the most recent industry and consumer surveys also give positive indications with regard to economic activity in the euro area. Therefore, it is likely that economic activity will accelerate in the second half of 1999 and the year 2000.

When assessing the risks for price stability, the ECB does also monitor the external value of the euro. The weakening of the effective exchange rate of the euro, which remained at around 8% between the start of the year and early September, lent itself to an increase in import prices denominated in euro.

Taking into account all available information, the outlook for the preservation of price stability remains favourable. However, recently inflationary risks have increased slightly. In the coming months it will therefore be necessary to monitor developments in the monetary aggregates and credit aggregates. In addition, the short-term effects of the increase in oil prices and exchange rate developments on consumer prices need to be taken into account. The latter factors should not affect the outlook for price stability as long as wage increases remain moderate. The wage round for the year 2000 will, however, play an important role in future price developments.

On the basis of this current assessment of the monetary, financial and economic situation, the Governing Council of the ECB left the central bank interest rates unchanged at yesterday’s meeting.

Economic policy arena: fiscal policy and the employment markets

The success of Monetary Union and the future of Europe will also depend on fiscal and structural policies in the Member States significantly improving the structural conditions for further economic development and, in particular, employment developments. As is evident from the waning consolidation efforts following the beginning of Monetary Union and the continuing high level of unemployment, in general, the initial experiences in this area were rather disappointing.

Most Member States are currently still very far from meeting the medium-term requirement for a balanced budget laid down in the Stability and Growth Pact. The measures currently planned are, for the most part, insufficient to achieve a sustained reduction in the long-term structural deficits. This problem is becoming particularly obvious given the current low interest rates in the euro area, which have, in themselves, tended to increase the scope for fiscal consolidation. In view of the relatively positive economic outlook for the euro area, fiscal policy should be taking advantage of this opportunity to make cuts in expenditure in order to achieve a more sound fiscal policy in the medium term.

The high level of unemployment in Europe is primarily of a structural nature, which is evident when a comparison is made with the United States. Whilst in the United States, over the last twenty years, unemployment has declined significantly during the economic cycles as a result of a successful deflationary and stability policy introduced by the Federal Reserve, unemployment in Europe has increased further in the same period. Since the beginning of the year, the rate of unemployment has stabilised at around 10% in the euro area. Those Member States with more flexible employment markets and more restrained wage bargaining generally have much higher levels of employment than the average in the EU.

It is still hoped that the current upturn will not be slowed down by excessive demands for higher wages and will be used to make decisive structural policy reforms. Flexibility in the employment and commodity markets would therefore appear to be urgently needed.

As you know, at the summit in Cologne the European Council called for an Employment Pact to be created with the aim of achieving a sustained reduction in unemployment. The Pact underlines the need for the implementation of structural reforms in Europe. It is hoped that the Pact will achieve this objective. Together with the national fiscal policymakers, the unions and the European Commission, the Eurosystem will also take part in the macroeconomic dialogue. We shall use this dialogue to make it absolutely clear to the other parties that structural unemployment cannot be reduced without decisive reforms. Short-term activism intended to stimulate employment cannot solve the structural elements of the problem and the Eurosystem will insist that all measures envisaged by other parties are consistent with the need to preserve price stability.

The international role of the euro

Finally, I should like to talk in more detail about the international role of the euro. The euro is the currency of an economic area consisting of almost 300 million inhabitants which represents around one-sixth of the world’s gross domestic product. Behind the US dollar and ahead of the Japanese yen, the euro is the second most used currency at the international level. This is a reflection of the former significance of the national currencies which the euro replaced, as well as the important role that the euro area plays in the global economy.

The ability of the Eurosystem to preserve price stability has not been hampered by the start of the internationalisation of the euro. Initial experiences have shown that the development of the euro as an international currency will be determined, above all, by the international financial markets. In this context, the use of the euro in the private economic sector as an investment and issuing currency and as a means of payment is of great importance.

The international interest in the euro is evident, for example, from international new issues. According to information from the Bank for International Settlements, the volume of new issues in euro (calculated as a gross figure) almost doubled in the first half of 1999 compared with same period last year. By contrast, the increase in new issues in US dollars was around 10% weaker. New issues in the Japanese yen and the Swiss franc either stagnated or even declined somewhat.

With regard to the role of the exchange rates between the euro and other important currencies outside of the EU, in particular the US dollar, the Eurosystem made an unambiguous choice when shaping its monetary policy strategy. This strategy clearly excludes any explicit or implicit targets or target zones for the euro exchange rate. The pursuit of an exchange rate target could easily jeopardise the preservation of the price stability objective and therefore hamper real economic developments.

It should also be noted that exchange rate fluctuations are often caused by structural or fiscal policy as well as divergent economic developments. Monetary policy would be significantly challenged and its credibility put at risk, if such exchange rate fluctuations had to be contained by monetary policy. The absence of an exchange rate target does not mean that the ECB views the exchange rate of the euro as irrelevant or does not take it into account. On the contrary, the exchange rate is monitored and analysed as a potentially important monetary policy indicator.

The success of the euro in its relatively early stage of life has led, in many places outside the EU, to suggestions that domestic monetary policy should be more closely linked to that of the Eurosystem. Suggestions range from pegging the exchange rate to the euro to the introduction of the euro as a parallel currency or even as a replacement currency. In principle, the ECB maintains a totally neutral position with regard to such developments. We will neither endeavour to strengthen the international role of the euro nor to prevent such developments from taking place.

In this respect, I should like to emphasise that when formulating monetary policy the Governing Council of the ECB is bound by the mandate to ensure price stability in the euro area set out in the Maastricht Treaty. This means that developments in neighbouring European countries are taken into account to the extent that the outlook for these countries influences price developments in the euro area. However, the ECB cannot and may not assume any obligations with regard to monetary or general economic policies in other countries, irrespective of the role the euro plays in those countries or of the size of the economies concerned.

I should like to point out that the Maastricht Treaty envisages a clear and transparent procedure which lays down the conditions for countries wishing to join the euro area. There are three stages. The basic prerequisite is that the country is a member of the EU which is linked to specific criteria. In addition, the country concerned is expected to join the Exchange Rate Mechanism II, for which it must similarly fulfil certain economic criteria. Finally, the convergence criteria must be complied with, which should ensure that a candidate country wishing to join provides evidence of sufficient economic convergence with the euro area. In addition to sound public finances and a high degree of price stability, they must also provide evidence of relatively low long-term interest rates and stable exchange rates. The European Council decides whether a country is eligible to join in Monetary Union and calls upon the ECB and the European Commission to give an Opinion.

Conclusion

I shall now come to a close. The ECB has been responsible for monetary policy in the euro area for nine months now. So far, we believe that the ECB's monetary policy, the new monetary policy strategy and the new range of instruments have passed their first test very well indeed. Many international observers share this view.

The real art of monetary policy will continue to be maintaining price stability in the euro area in the foreseeable future. Faith in a currency cannot be achieved by way of national or international legislation. Rather, the ECB must try to inspire new faith in the euro on an almost daily basis in order to build up credibility over time. It would be wise to develop this credibility so that the ECB's monetary policy is also sufficiently prepared for difficult phases in the future.