Mr Noyer reports on monetary policy-making in Europe

Speech presented by Mr Christian Noyer, Vice-President of the European Central Bank, to the Spanish Association of Corporate Treasurers (ASSET), held in Barcelona, on 19 November 1999.

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Ladies and gentlemen,

It is a pleasure for me to be here in Barcelona today. I should like to thank the organisers of this congress very much for giving me the opportunity to speak to you on the subject of "Monetary policy-making in Europe".

It is now nearly 11 months since the Eurosystem, consisting of the European Central Bank (ECB) and the 11 national central banks (NCBs) of those EU Member States that introduced the euro on 1 January 1999, assumed its tasks, i.e. deciding and conducting the single European monetary policy. 11 months of practical experience is, of course, not long enough for a conclusive stocktaking exercise, but it certainly seems appropriate, at this stage, to review some of the lessons we have learned.

Let me start by recalling what, in essence, monetary policy-making in Europe is about.

The Maastricht Treaty (formally the Treaty on European Union, which has now become part of the Treaty establishing the European Community) assigns to the single monetary policy the primary objective of maintaining price stability in the euro area. In order to achieve this goal successfully, both a high degree of central bank independence and the prohibition of monetary financing by the government are tenets of the monetary policy framework enshrined in the Treaty.

There is no doubt concerning the overriding importance attached to the primary objective of price stability. By safeguarding price stability in the euro area over the medium term, the single monetary policy is supposed to make the best possible and most lasting contribution to the achievement of other Community objectives, such as high employment and sustainable non-inflationary growth.

Among central bankers and economists, the predominant view is that a long-run trade-off between inflation and output growth does not exist. Attempting to use monetary policy to increase real economic activity above its sustainable level will, in the long run, simply lead to higher inflation and will not foster economic growth. Moreover, theoretical considerations as well as empirical evidence over several decades suggest that high rates of inflation are clearly unhelpful - indeed detrimental - to growth and employment in the long term. A large number of economic arguments point to the benefits of price stability for economic growth and employment prospects. Stable prices eliminate or reduce economic costs such as those arising from inflation as a result of uncertainty about the outcome of investment decisions, the distortionary effects on the tax system, rising risk premia in long-term interest rates and reduced allocative efficiency of the relative price mechanism and market systems. Monetary policy must take into account the fact that the horizon for decisions by economic agents is rather long-term in nature. By guaranteeing price stability, monetary policy provides an anchor for economic decision-making. This clearly supports the efficient functioning of the price mechanism, which is conducive to the best allocation of scarce resources. Price stability is hence a means of promoting sustainable economic growth and the creation of employment, and of improving productivity levels and living standards.

This discussion also sheds light on what is certainly the greatest economic challenge facing the euro area at present, namely, the need to reduce the current unacceptably high level of unemployment in Europe. In the light of this problem, we have to realise that even in an ideal situation where monetary policy is very successful in maintaining price stability, the contribution of monetary policy to reducing unemployment in Europe can only be a limited one. Many empirical studies show that the high unemployment rate is mostly the consequence of structural rigidities within the European labour and goods markets. The European unemployment rate has, indeed, been high or even rising over the business cycles in the past decade. Only structural reforms, preferably of a comprehensive nature, can therefore tackle the underlying impediments to employment growth.

When deciding on monetary policy, the Eurosystem must acknowledge the capabilities and limitations of monetary policy implied both by general economic principles and by the structure of the euro area economy. This is also reflected in the formulation of the Eurosystem's monetary policy strategy, which is designed to maintain price stability in the euro area.

The strategy was announced by the Governing Council on 13 October 1998. It is designed to fulfil two important functions. First, it structures the monetary policy-making process so that the Governing Council of the ECB is provided with all the information and analysis it requires to take appropriate monetary policy decisions. Second, the strategy ensures that policy decisions, including the economic rationale on which they are based, can be presented in a clear, coherent and consistent way to the public. By providing a stable framework for making and explaining monetary policy decisions, the strategy bolsters the credibility and effectiveness of the single monetary policy.

In designing the monetary policy strategy of the Eurosystem, the Governing Council also had to respect a number of practical issues and difficulties which arose because of the uncertainties created by the so-called shift of regime associated with the transition to Monetary Union. Where there were previously 11 open, generally small economies, there is now one large, relatively closed single currency area. The challenges implied by this transformation in the landscape of monetary policy are profound.

For the time being, relatively little is known about the details of the transmission of monetary policy measures to the real economy in the euro area. It is possible that the shift of regime has changed the behaviour of economic agents, and hence, the structure and functioning of the euro area economy. Consequently, together with experts at the NCBs, the ECB has embarked on an intensive programme of analysis and research on these issues.

One obvious impediment in this respect is the limited availability of harmonised statistical data for the euro area. This is only natural, given that the euro area did not exist as a single currency area before January 1999. In the last couple of years the European Monetary Institute (EMI) and the Statistical Office of the European Commission (EUROSTAT) together with central banks and statistical offices in EU Member States have put a lot of effort into developing harmonised statistical concepts for monetary and economic indicators. By the beginning of this year, when Stage III of EMU started, a lot had already been achieved in this respect. The quality and availability of statistics on the euro area has increased significantly over the past few quarters, particularly in the areas of money and banking and balance-of-payments statistics, but also across a wide range of economic statistics. This process of improving the quality and the availability of statistical data covering the euro area will continue.

Against the background I have just described, the Governing Council has selected a monetary policy strategy that embodies a new and distinct approach, which reflects the unique circumstances and institutional environments faced by the Eurosystem. The design of a clear, credible and effective monetary policy strategy for the Eurosystem required an appreciation of the environment in which the Eurosystem operates. This environment imposes certain constraints on monetary policy in the euro area, which the Eurosystem's strategy must acknowledge and respect. The stability-oriented monetary policy strategy therefore avoids "mechanistic" monetary policy responses to only a few indicators or forecasts. As the environment of monetary policy is complex and the interpretation of the indicators difficult, there is no simple rule for monetary policy.

The Eurosystem's strategy consists of three main elements that were announced a year ago.

First, the primary objective of monetary policy has been quantified with the publication of a definition of price stability, which serves as a guide for inflation expectations and against which the Eurosystem can be held accountable. Price stability is hence defined as annual increases of below 2% in the Harmonised Index of Consumer Prices (HICP) for the euro area. This definition illustrates that both inflation and deflation are regarded as being incompatible with price stability. It was also announced that price stability is to be maintained over the medium term, imparting a forward-looking orientation to the strategy as a whole.

Second, in order to maintain price stability according to this definition, money is accorded a prominent role. Monetary developments are closely monitored and analysed, in particular in relation to a quantitative reference value for monetary growth. In December 1998, the reference value was set at an annual growth rate of 4½% for the broad monetary aggregate M3. In line with the medium-term orientation of the strategy, this reference value was based on assumptions concerning the medium-term developments in prices, real GDP and the velocity of circulation.

Third, in parallel with this monetary analysis, a broadly based assessment of the outlook for price developments in the euro area is being undertaken. This assessment encompasses a wide range of indicator variables, including macroeconomic projections produced both within and outside the Eurosystem.

Using the information obtained from this analysis, the Governing Council of the ECB comes to a decision on the level of short-term interest rates that will best serve the maintenance of price stability in the euro area as a whole in the future.

The decision of 4 November to raise the ECB interest rates demonstrates the forward-looking character of our strategy. Owing to the lags in the transmission mechanism, our monetary policy could not wait until inflation stood at 2% or above. The Eurosystem raised interest rates in order to counter the upward trend of the balance of risks to future price stability, which was observed during the summer. This policy move should help to stabilise inflation expectations safely at below 2%. By maintaining a favourable outlook for price stability, this decision also contributed to making economic growth in the euro area sustainable over the medium term. In fact, a monetary policy that reacts too late to emerging inflationary pressures runs the risk of being forced to take much stronger measures at a later stage. Eventually, such a policy would only exacerbate cyclical fluctuations without enhancing the long-term potential of the economy.

Let me now turn to a number of criticisms of the Eurosystem’s monetary policy which have been raised since the strategy was first announced. I should like to address some of these concerns in the remaining part of my presentation.

Some observers have argued that the strategy is “asymmetric” and that the Eurosystem will be more concerned about inflation than it is about deflation. These assertions are often based on the perceived lack of a precise lower bound to the definition of price stability, which is contrasted with a clear upper bound of 2%. Critics point out that such asymmetry will impose a drag on the overall performance of the euro area economy and risks, under certain circumstances, triggering a deflationary spiral.

Let me put it bluntly: I do not share this view. First, I should like to draw your attention to the fact that the use of the word “increases” in the definition sets the floor at zero for the lower bound. The absence of a specific numerical value for the lower bound reflects, in the first place, the uncertainties we face concerning the existence and magnitude of the so-called measurement bias in the HICP. This bias arises mainly from changes in spending patterns and quality improvements in those goods and services that are included in the basket used to define a specific price index. Such biases cannot always be fully corrected in the construction of price indices. The measurement bias typically causes CPIs to overstate the “true” rate of inflation. Although the HICP is based on a concept that puts considerable emphasis on reducing or eliminating the measurement bias, some overstatement cannot be excluded. Second, we need to keep in mind the fact that the ceiling of 2% leaves sufficient room for small increases in the price index, thereby minimising the risk of falls in the price index. I should like to emphasise the fact that the Governing Council of the ECB has already demonstrated that it would deem neither inflation nor deflation in the euro area to be consistent with the maintenance of price stability. The two interest rate decisions taken on the basis of the Eurosystem’s strategy in April and November are clear examples of this commitment.

Another criticism of our strategy that is sometimes voiced concerns the “prominent role for money”, reflected, in part, by the announcement of a reference value for M3 growth. Here we can differentiate between two camps. Some of these critics argue that M3 growth should not influence monetary policy decisions by the Governing Council. However, others criticise the Eurosystem for not basing monetary policy decisions almost exclusively on deviations of M3 growth from the reference value, as they are convinced that money is the best indicator for monetary policy.

I reject the criticisms of both camps. Let me explain why. First, I disagree with the view that money should play no or only a small role in the ECB's strategy. Empirical studies show that M3 for the euro area has a stable relationship with the price level over the medium term. Such a stable relationship with price developments has not been found for any other indicator variable at this place in time. Moreover, there is evidence that monetary aggregates contain useful information for future macroeconomic developments. This is the reason why monetary growth is analysed very closely by the Governing Council.

At the same time, I do not think that the ECB should focus uniquely on money. The problem with doing this is that in the short run, the relationship between money and prices can be distorted by portfolio shifts and institutional factors. Short-term developments in money therefore need to be analysed very carefully. Against this background, the Governing Council of the ECB has always communicated to the public that it cannot and will not react mechanically to deviations of actual monetary growth from the reference value. Let me also point out that the Governing Council has, from the very beginning, rejected the idea of being held accountable for failing to keep monetary growth close to the reference value every year. In this sense, the concept of the Eurosystem's strategy is different from monetary targeting in the traditional sense. For this reason, the Eurosystem's strategy is based on two pillars. Monetary policy should always react to all the information available with a view to maintaining price stability in the medium term.

This is also the answer to those critics who argue that the ECB disregarded high money growth when it lowered interest rates in April, but put much emphasis on high money growth when it raised interest rates in November. In fact, in both situations we based our decision on both pillars of the strategy and also assessed the prevailing monetary developments at the time in the light of other information available. When we cut interest rates on 8 April, only two months of monetary data for 1999 were available. At that point in time, the three-month moving average for M3 stood at 5.1%. Let me recall that we had always emphasised that "substantial or prolonged deviations from the reference value under normal circumstances signal risks to price stability in the medium term". However, the data showed that M3 growth was only slightly above the reference value then and that there was not evidence as yet of a prolonged deviation. By contrast, there were several indications that M3 was temporarily distorted upwards in early-1999 as a result of the changeover to Stage Three of Economic and Monetary Union (EMU), also against the background of historically low long-term rates. Thus, at that point in time it was difficult to see whether M3 growth in early-1999 would reveal upside risks to price stability. At the same time, the information from the second pillar of our strategy showed clear downside risks to future price developments in April. The situation was different in November. Here it was clear that monetary growth had increased considerably over the course of 1999. The three-month average stood at 5.9% for the period from July to September 1999. Even when we corrected the data in accordance with the somewhat specific movements of M3 in January and February, we could see that the annualised figure for M3 growth from March to September was 6.1%. All this took place in a significantly different economic environment compared with April. I think that this comparison between the two decisions to change ECB interest rates in April and November is very useful. It shows that we do not react mechanistically to individual indicators, but always interpret the movements and signals in all of the indicators evident in both pillars in conjunction with each other. As we can see, this is a more reasonable approach than relying on a simple indicator, given that we are living in a complex world.

There is another line of argument which is that the monetary policy of the Eurosystem focuses too closely on cyclical developments. This would be inconsistent with the public commitment to a medium-term orientation. This body of opinion often refers to the explanations delivered on the occasion of the interest rate cut in April 1999. These critics claim that this move was mainly intended to support employment and growth prospects in the short term.

This is, in my view, an unfortunate miscomprehension of the facts and I shall try to be clear on this point. Our monetary policy has had, and will continue to have, a forward-looking medium-term orientation, with the maintenance of price stability in the euro area as our focus. As mentioned, in April 1999 our thorough review of monetary, financial and economic developments revealed downward risks to price stability stemming basically from the cyclical slowdown that occurred in the aftermath of the financial turmoil in emerging markets during mid-1998. Both the forward-looking and medium-term orientation of the single monetary policy made it necessary for the Governing Council to take action: interest rates were cut.

The focus on the primary objective of price stability driving the decision in April does not exclude the fact that in many cases the policy action required to maintain price stability helps to stabilise real activity in the short term. Risks to price stability are very often related to cyclical developments and these policy aims are therefore complementary rather than conflicting. At the same time, I should like to point out that we must not give the false impression that the short-term impact of necessary monetary policy actions on real activity will always be favourable. Situations may occur, for example when wage settlements jeopardise price stability, or when there is a short-term trade-off between adverse developments in real activity, on the one hand, and deviations from price stability on the other. In this case, it is important that the overriding priority of maintaining price stability is absolutely clear. Any ambiguity on this point would simply endanger the credibility, and therefore the effectiveness of monetary policy.

Last but not least, I should like to make a few remarks with regard to the most frequently expressed criticism, namely that the Eurosystem is a secretive institution that does not meet the required standards of transparency and clarity.

Key features of the ECB's communication policy are our Monthly Bulletins and the monthly press conferences given by the President of the ECB and myself. The press conferences usually directly follow the first Governing Council meeting of each month. During these press conferences, the President makes an introductory statement summarising the Governing Council's discussions and conclusions before answering questions from journalists. As the statement is agreed beforehand, in substance, with all the Governing Council members, it is similar to what other central banks call minutes. I am convinced that informing the public of such a united position in the Governing Council is more valuable for establishing credibility and reducing uncertainties in the markets than publishing details of a Governing Council discussion, which would naturally be difficult to assess for those not present at the meeting.

Moreover, the press conference provides prompt information in an even-handed way, and it offers the opportunity for immediate two-way communication. As far as I am aware, no other central bank regularly communicates with the public in such a prompt and open manner immediately after its monetary policy meetings. We are convinced that this contributes to transparency and thus gives important and clear guidance.

These press conferences are a tangible expression of the Eurosystem's commitment to being open, transparent and accountable in its conduct of monetary policy. Obviously, journalists, financial markets and the public are still learning about the new monetary policy strategy in the euro area and, over time, the Eurosystem will further improve its communication.

In this respect, it has also been argued that we do not release sufficient information about our analysis. More specifically criticism has been expressed to the effect that the Eurosystem is currently not publishing its inflation forecasts. May I remind you, therefore, that the inflation forecast is not a key element of our strategy? An inflation forecast is just one of the many pieces of information which we use. Its importance should not be exaggerated. Our quantitative definition of price stability is not an inflation target in the same way as those of other central banks, nor are we targeting an inflation forecast. In our view, a single forecast is not a sufficient statistic given the complexity of economic relationships and the existing uncertainties about the future. We are living in a complex environment in which policy decisions cannot be simply related to a few or even one information variable. There is also the risk that we are chasing our own tail. In fact, our monetary policy always aims to respect the definition of price stability. The advantage of publishing a forecast would be that it would make one more piece of information, which plays a role in the decision-making process, transparent. That being said, the Governing Council will have to reconsider the issue once our macroeconometric models are deemed to be sufficiently reliable. This may still take some time. Let me now conclude by saying that I am happy to contribute to a project of such historical dimension and so are my colleagues in the ECB and those at the NCBs belonging to the Eurosystem. Monetary Union has had a successful start and the monetary policy strategy of the Eurosystem, on the basis of which the Governing Council has taken and will continue to take its monetary policy decisions, has contributed to this success. At the same time, we should recognise the fact that monetary policy alone cannot tackle all of the economic challenges facing the euro area. In particular, it cannot reduce the euro area's unacceptably high level of structural unemployment. The main contribution the single monetary policy can make to the welfare of the people in the euro area will be the maintenance of price stability in the medium term. Although monetary policy-making in Europe is not an easy task, I am confident after the experience of the first 11 months that the Eurosystem is both determined to assume this task and is well equipped to do so.