

Economic and Monetary Union in Europe—the Challenges Ahead

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From the European perspective, the title of this year's Jackson Hole Symposium, "New Challenges for Monetary Policy," is particularly appropriate. Economic and Monetary Union (EMU) in Europe is a unique project and its consummation with the introduction of the single monetary policy on January 1, 1999, took place less than eight months ago. Today, given the time available, I will not endeavor to review all the challenges that are raised by EMU comprehensively. I shall have to be selective, largely focusing on the primary objective of the Eurosystem, which is to maintain price stability in the euro area. In this context, let me briefly explain our terminology, which may perhaps not be known to everybody as yet. The "Eurosystem" is the name we gave to the European Central Bank (ECB) and the currently eleven national central banks of those countries that have introduced the euro. The "euro area" comprises these eleven countries.

I should like to start with some observations on the objective and limitations of monetary policy in the euro area. Owing to the successful process of disinflation and convergence within Europe over the past decade, the launch of the euro last January took place in an environment of price stability that few observers would have predicted only a few years ago. Consumers and firms are already reaping the benefits of this environment. The relative price signals on which the

efficiency of the market mechanism relies are not obscured by volatility in the general level of prices. By avoiding the costs and distortions inflation would impose on the economy, price stability is contributing to the growth and employment potential of the euro area.

This contribution is substantial. Unfortunately, it is all too easily taken for granted. Memories of the still recent past relating to the consequences of high and unstable inflation tend to fade rapidly. We are sometimes already hearing the argument that, given that price stability has been achieved, monetary policy should now be re-oriented away from its primary objective of price stability toward other goals. One of the challenges facing the Eurosystem is to maintain the support of the broad public constituency necessary to resist these calls, which—as I hardly need to point out to such a distinguished audience of central bankers and monetary economists—are misguided and ultimately counterproductive. However, it can be said that the situation is the same as that in the world of sports; winning a championship and reaching the top is difficult, but staying there is even harder.

The institutional framework for European monetary policy, as created by the Maastricht Treaty (i.e. the Treaty on European Union, which has become part of the treaty establishing the European Community, or the EC Treaty, in short) is well suited to meeting this challenge. Most importantly, the single monetary policy has been clearly assigned the primary objective of maintaining price stability in the euro area. To facilitate the achievement of this goal, the ECB and the national central banks have been accorded a high degree of institutional independence so as to protect monetary policy decisions from undue external interference.

The treaty imposes several duties and tasks on the ECB. However, there is no doubt that the objective of price stability is overriding. For example, the treaty stipulates—if I may quote—that the Eurosystem “*without prejudice to the objective of price stability, ...shall support the general economic policies in the Community, with a view to contributing to the achievement of the objectives of the Community,*” which include “sustainable and non-inflationary growth” and “a high level of employment.”

Given the clear priority attached to the primary objective of price stability, how does the ECB address these other treaty obligations? Let me make three points in this regard.

First, among economists and central bankers, there is overwhelming agreement that there is no long-run trade-off between real activity and inflation. Attempting to use monetary policy to raise real economic activity above its sustainable level will, in the end, simply lead to ever higher inflation, but not to faster economic growth. I am convinced that the best contribution monetary policy can make to sustainable growth and employment in the euro area is to maintain price stability in a credible and lasting manner, allowing the considerable benefits of price stability to be reaped over the medium term. This is the economic rationale underlying the EC Treaty and the Eurosystem's monetary policy strategy.

Second, it is generally acknowledged that monetary policy does affect real activity in the short run. Although the focus must always be on price stability, in many cases the policy action required to maintain price stability will also help sustain short-run economic and employment prospects. The reduction of the Eurosystem's main refinancing rate on April 8 was a case in point. Following the Asian and Russian financial crises last year, global demand weakened. Weaker external demand led to a shift in the balance of risks to price stability in the euro area toward the downside, as demand pressures abated. As monetary indicators did not signal inflationary risks at that time, the Governing Council of the ECB concluded that a cut of 50 basis points in the main refinancing rate best served the maintenance of price stability. This lower level of interest rates may also be supportive of real activity and employment in the short run. Our eyes must always be firmly focused on the goal, on our goal, to maintain price stability in the medium term. Our monetary policy does not explicitly aim at influencing the business cycle. However, as said in many cases, the necessary monetary policy measures to achieve our goal also tend, almost automatically, to work in the right direction from a cyclical point of view.

This leads me to my *third* point. In situations where monetary policy might face a short-term trade-off between adverse developments in

real activity and deviations from price stability, the overriding priority accorded to countering the latter must be made absolutely clear. Any ambiguity on this point will simply endanger the credibility, and therefore the effectiveness, of the monetary policy response. This does not mean that the policy action must be draconian. The medium-term orientation of the Eurosystem's monetary policy strategy permits a gradualist and measured response to previously unforeseen threats to price stability, should this be regarded as appropriate, depending on the nature of the threat. Such gradualism may help to avoid the introduction of unnecessary uncertainty into the real economy.

Recognition and an understanding of these three central points are essential for the implementation of a successful monetary policy. Communicating both the objective and the limitations of monetary policy to the public is a vital issue to which I will return later in my remarks.

But it would be remiss at this point if I did not address what is surely the greatest economic challenge facing the euro area at present, namely the unacceptably high level of unemployment. There is a broad consensus that unemployment in the euro area is overwhelmingly structural in nature. Monetary policy cannot solve this problem. National governments bear the main responsibility for structural economic reforms. In particular, further reforms of the tax and welfare systems are required in many European Union (EU) countries in order to increase the incentives to create new jobs and to accept them. Wage moderation can also have a significant beneficial impact. Monetary policy makes its best supportive contribution by providing the environment of price stability in which structural reforms can work most effectively.

It should be recognized that the implementation of EMU has made it even more urgent to improve the flexibility of labor and goods markets. In this context, it would very likely be the wrong answer if governments were to try to create a "social union," harmonizing social security systems and standards at a very high level. The ECB will continue to cajole governments into implementing necessary and long overdue reforms, but the final hard decisions—and I acknowledge that they are hard decisions, since the considerable benefits of structural

reform often only become apparent with time—lie with the national authorities. In those countries where appropriate structural reforms have been implemented and wage growth has been moderate, unemployment is either low by euro area standards or is falling more rapidly. These experiences offer important lessons for other countries in the euro area. Fortunately, a broader awareness of the necessity of structural reforms recently seems to be emerging in Europe. Of course, ultimately only sustained action will count. The cyclical recovery that is under way is no substitute for such action.

Thus far, I have largely discussed the goal of the single monetary policy. How is this goal to be achieved? At the heart of the answer to this question is the Eurosystem's monetary policy strategy. The strategy has two closely related aspects. *First*, the strategy must structure the monetary policy-making process in such a way that the Governing Council of the ECB is presented with the information and analysis required to take appropriate monetary policy decisions. *Second*, the strategy must ensure that policy decisions, including the economic rationale on which they are based, can be presented in a clear and coherent way to the public. The communication policy as part of the strategy obviously has to be consistent with the structure of the internal decision-making process.

In designing the Eurosystem's strategy, the Governing Council of the ECB recognized the new circumstances faced by monetary policy in the euro area. Where there were previously eleven 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.

Relatively little is known as yet about the transmission mechanism of monetary policy in the euro area after the transition to Monetary Union. One important challenge for the Eurosystem is to obtain a better knowledge of the structure and functioning of the euro area economy and the transmission mechanism of monetary policy within it, so that policy actions can be implemented accordingly. Together with experts in the national central banks, the ECB has embarked on an intensive program of analysis and research into these issues.

One obvious problem related to the fact that the euro area did not exist as a single currency area in the past regards the availability of statistical data. Compared with national central banks, we do not have the same amount of long historical time series of monetary and economic indicators, based on harmonized statistical concepts, at our disposal. However, we have already developed quite reliable estimates for a number of these historical series, and the quality and availability of current statistics on the euro area have increased significantly over the last few quarters, for example, 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.

It would have clearly been unwise for the ECB to develop a strategy that relies mechanically on the signals offered by a single indicator or forecast in order to take monetary policy decisions. Indeed, such a simplistic approach to monetary policy-making is unwise in all circumstances. Our knowledge of the structure of the euro area economy and the indicator properties of specific variables—although improving rapidly—is simply too limited.

The primary objective of monetary policy has been quantified with the publication of a definition of price stability, against which the Eurosystem can be held accountable. This definition illustrates our aversion to both inflation and deflation since it defines price stability as annual *increases of below 2 percent* in the Harmonized Index of Consumer Prices (HICP) for the euro area. To maintain price stability according to this definition, monetary developments are closely monitored against a quantitative reference value for the broad benchmark aggregate, M3. In parallel, a broadly based assessment of the outlook for price developments in the euro area is undertaken. This assessment encompasses a wide range of indicator variables, including inflation projections produced both inside and outside the Eurosystem. Using all this information, the Governing Council comes to a decision on the level of short-term interest rates that best serves the maintenance of price stability over the medium term.

On the basis of this strategy, I am confident that the Governing

Council has taken – and will continue to take – appropriate monetary policy decisions. The effectiveness of these policy decisions will depend, in large part, on the credibility of the single monetary policy. Transparent and accountable policy-making can help to build up a reputation and, hence, credibility. Transparency and accountability, in turn, rely on clear and effective communications between the Eurosystem and the public.

In this regard, the Eurosystem faces an especially formidable task. As mentioned earlier, the euro area currently consists of eleven different sovereign nations, each with its own distinct monetary history and heritage. With each policy announcement or Monthly Bulletin, the Eurosystem must thus communicate with the public of eleven different countries and must speak in all eleven different official languages of the European Union. Such a situation is unprecedented. This diversity of language, history, and culture across the euro area raises further challenges for the ECB.

Over the years, each national central bank had developed its own strategy and, linked to this, its own “monetary policy language” for communicating with the public in the nation it served. This language reflected the unique circumstances of the country in question. The process by which the public learned this monetary language from the statements and behavior of the national central bank was largely subconscious. Over time, the strategies and the related language and conventions of monetary policy came to be so well understood as to be almost second nature. In these circumstances, private economic behavior was shaped by the monetary policy environment.

Many of us have experienced the problem of trying to learn a second language in adult life. This rarely comes as easily as learning your native tongue as a child. It is certainly not a subconscious process, but rather one that requires effort and perseverance. It is often difficult to overcome the habits and conventions of one’s first language, which are inevitably somewhat at odds with those of a foreign tongue. Of course, it is easier to learn a language that shares common roots with one’s own. Nevertheless, to obtain any degree of fluency, there is no alternative to long hours practicing pronunciation, studying grammar,

and learning vocabulary. Even then, the idioms and slang of the new language are sometimes hard to follow. There are no easy shortcuts.

With the adoption of the euro last January, the public, financial markets, and policy-makers in the euro area have all had to get used to a new monetary policy environment and have, thus, had to learn a new “monetary policy language.” The Eurosystem’s monetary policy strategy has been designed, in part, to make this learning process as straightforward as possible. Continuity with the successful strategies of the national central banks prior to Monetary Union was one of the guiding principles governing the selection of the monetary policy strategy. Nevertheless, given the changed environment for monetary policy, a new strategy with a new vocabulary had to be developed, reflecting the unique and novel circumstances facing the Eurosystem.

Some commentators have suggested that the Eurosystem simply adopt the strategy used by another central bank or by a national central bank in the past. Tellingly, such observers often suggest the strategy they know best: Americans suggest using the Federal Reserve as a model; Britons, the Bank of England; Germans, the Bundesbank. However, the Eurosystem cannot simply adopt a strategy designed by another central bank for a different currency area under different economic circumstances. A strategy that might have been suitable in one situation may be quite inappropriate for the unique and novel circumstances facing the Eurosystem, given the very different economic structure and environment confronting it.

A key feature of the ECB’s communication policy is the monthly press conference given by the ECB’s vice president and myself, usually immediately following the first Governing Council meeting of each month. During these press conferences, I make an introductory statement summarizing the Council’s discussions and conclusions before answering questions from journalists. As the statement is agreed, in substance, with all the Council members beforehand, it is similar to what others call minutes. 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 communicates with the public in such a prompt manner immediately after its monetary policy meetings.

These press conferences are a tangible expression of the Eurosystem's commitment to be open, transparent, and accountable in its conduct of monetary policy. In my view, our commitment to openness should not be in doubt. However, ensuring that this openness translates into effective communications continues to be a challenge. Journalists, financial markets, and the public are still learning the new strategy and language of monetary policy in the euro area.

By its nature, the challenge of improving communications between the Eurosystem and the public is two sided. On the one hand, the ECB must use a clear and transparent language consistent with the strategy it has adopted. It must help the public understand the changes of emphasis and communication necessitated by the new monetary policy environment in Europe. We have made important progress in this regard over the last eight months, but I acknowledge that we still have some way to go. The ECB must do its utmost to be understood by its counterparts in the media that act as important intermediaries to the public at large. By learning from one another, we can improve the transparency, democratic accountability, and effectiveness of the single monetary policy.

Before concluding, I should like to add a brief comment on the likely future enlargement of the EU and, prospectively, the euro area. Currently, the EU negotiates the accession of six countries to the EU. Once the accession of new member states is decided, these countries have to fulfill the so-called convergence criteria if they want to join the euro area. The euro area can finally only be enlarged if the European Council, following an assessment by the ECB and the European Commission, decides that further member states of the EU are ready to adopt the single currency. New countries joining the euro area will be a challenge for us. For example, we will have to integrate the respective economy fully in our area-wide analysis of monetary, financial, and other economic developments in the euro area. Enlargement is a challenge we clearly welcome. I have no doubts that we can master it, not least as the EC Treaty outlines a clear and transparent procedure for

countries wishing to join the euro area. In simple terms, this can be viewed as involving three phases. First, a candidate country must join the EU, for which certain requirements must be met. Second, the candidate is expected to join the new exchange rate mechanism, ERM II. Third, as mentioned earlier, the country must fulfill the convergence criteria. In addition to fiscal discipline and inflation control, these criteria include a relatively low level of long-term interest rates and stable exchange rates.

Let me conclude. Monetary policy cannot solve all of the economic challenges facing the euro area — in particular, those concerning the urgent need to reduce the high level of structural unemployment. National governments are responsible for carrying out the required structural reforms. The Eurosystem makes its best contribution to area-wide growth and employment prospects by credibly focusing on the maintenance of price stability in the euro area.

I am confident that the monetary policy strategy adopted by the Governing Council of the ECB last October has been successful—and the monetary policy decisions that have been based on it over the last eight months—serve the fulfilment of this objective. Nevertheless, we will not become complacent. On the contrary, we will have to continue to invest substantially in analyzing the structure of the euro area economy, and in understanding the monetary policy transmission mechanism and the information content of the various monetary and economic indicators.

Monetary policy is most effective when it is credible. Transparent and accountable policy-making can help to build up a reputation and credibility. Effective direct communications with the public, including the financial markets, other policy-makers, and the media requires that we speak with one voice in an even-handed way with our diverse counterparties and audience. Successfully refining our area-wide communications aimed at making our strategy, and the monetary policy based on it, transparent so that it can be well understood by the large and varied population we serve, is one of the challenges faced by the Eurosystem and, by implication, is one of our priorities.