

MONETARY POLICY OF THE EUROPEAN CENTRAL BANK

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**İAV "The Euro and Turkish System" Seminar
Opening Speech
İstanbul
December 18, 1998**

The European Monetary Union (hereafter, the EMU) will come to life at the beginning of next year. The European Central Bank (hereafter, the ECB) will commence operations, and the Euro will become an official reserve currency.

Eleven of the 15 countries in the European Monetary System will link their domestic currencies to the Euro by January 1, 1999. They will stop issuing their own currencies three years later. There will no longer be independent domestic monetary and exchange rate policies. Instead, monetary and exchange rate policies will reflect the needs of the Euro region as a whole, as determined by the European Central Bank.

This stage has obviously not been reached easily or quickly. This new institutional arrangement was the product of years of effort. First the philosophical groundwork had to be established, before the technical work could even begin. The final stages were only reached gradually. The European Union was thoroughly thought out. Under German initiative, with French support and British technical assistance, and contribution of all others, the institutions were established which will be responsible for monetary and exchange rate policy decisions under the Maastricht Treaty and the Stability and Growth Pact.

Countries have made heroic efforts to satisfy the Maastricht convergence criteria. They have reduced their budget deficits, pushed down their inflation rates to less than 2 percent, and brought their growth rates close to 3 percent. Favorable global economic conditions made it possible to create an environment suitable for the proper functioning of the system. Meanwhile, the European Monetary Institute completed the necessary preparations for launching the ECB, and transferred its responsibilities to that Bank at the beginning of July 1998.

At its founding, there was a broad consensus that the ECB should be independent. There were continuing discussions about its main target, however, and even though this question seems to be solved, sometimes it still appears on the agenda. The main point being discussed is that while price stability is specifically mentioned in the

constitutional agreement as an objective of the ECB, the role of the growth and economic stability objectives is less clear. It is generally agreed that the primary task of central banks should be price stability, but some still argue that the price stability objective should not conflict but should cooperate with the growth and stability objectives. Others insist that since the existence of price stability brings about high employment and sustainable growth in the medium- and long-term, there is no conflict between the growth and price stability objectives.

I believe that the ECB's present policies, based on all these discussions, aim at price stability as its primary task, with sustainable growth and low unemployment as major objectives.

I also believe that the question of the general nature of the ECB's monetary and exchange rate policies in pursuit of price stability, sustainable growth and low unemployment is of concern not just for those eleven countries. Since the ECB's policies will have global effects, they are of global concern.

As you all know, the general outlines of the monetary policies to be pursued by the eleven countries whose currencies are tied to the Euro has already been determined. This has also created some new problems. But before discussing them, I would like to point out the main characteristics of the ECB.

The European Central Bank has four main characteristics.

First, it is **independent**. This independence means that it can decide on what monetary policy strategies to follow and what monetary instruments, especially short-term interest rates, to use in pursuit of its primary objective of maintaining price stability.

The ECB's Governing Council, consisting of the governors of the national central banks of the Economic and Monetary Union and the Executive Board of the ECB, will determine the basic outlines of the ECB's monetary policy. The chosen strategy will be carried out by the ECB's Executive Board, consisting of a governor, vice governor, and four members appointed by the President or Prime Minister of countries in the European Monetary System.

From the independence of the central bank governors on the Governing Council, one can infer a high degree of independence for the system. As I mentioned before, the ECB's independence in implementing monetary policy toward the price stability objective can be ensured in this way.

The second important characteristic of the ECB is its **credibility**. High credibility will increase the confidence of the public in the ECB's policies and objectives, which in turn will help it achieve its primary objective. The most important ingredients of credibility are transparency and success in attaining its monetary policy objectives. For years now the central banks of Germany, France, and England have been earning credibility, and the confidence of firms, institutions, and individuals in these banks has increased considerably. The ECB, established in an environment of confidence provided by the credibility of national central banks, believes its growing credibility will translate into confidence in its conduct of monetary policy.

The third important characteristic of the ECB is **transparency**, already mentioned as one of the keys to greater credibility. Transparency means openness about the ECB's objectives, its policy implementation, its monetary policy deliberations, and the forward-looking orientation of its policies.

The ECB has explained, clearly and explicitly, that its main goal is maintaining price stability, and described the strategies by which it seeks to achieve it. I have already pointed out the additional issues of growth and unemployment. There is still discussion, but there is consensus concerning the primary objective. Discussion of these topics will continue in publications, announcements, and speeches by ECB authorities, and discussions. This kind of transparency is an important characteristic of the ECB.

The ECB will be accountable for its policy changes and for its announced policy intentions. This will contribute to transparency in its daily operations.

In addition, for the sake of transparency the minutes of ECB Executive Committee meetings should be made public. On this issue, the ECB has one concern. If a member of the committee approves a decision that is not advantageous for his own country, it may cause some problems. Indeed, the publication of the minutes of meetings years later could create some risks. At this stage, I find this a reasonable objection. Maybe in time this problem can be solved.

The fourth important characteristic of the ECB is that to reduce uncertainty, **policy making and economic indicators are treated on a forward looking basis**. The Bank's fundamental strategy is to calm down expectations for the future, since uncertainty is the most important ingredient of instability.

The main sources of the ECB's monetary policy, which is based on these principles, is thus determined. These are monetary aggregates, inflation targets, and other intermediate objectives such as selected monetary indicators, and finally the conduct of monetary policy in the light of all these elements. The ECB has indicated that even if it has an inflation target, it will not announce it. These monetary policy conditions absolutely guarantee that there will be some uncertainties and questions, and the first question will be whether it will be possible to lower the inflation rate below 2 percent when the intermediate targets are indicators calculated using the monetary aggregates of member countries. Other questions follow: Will the mechanisms of monetary policy transmission still work efficiently? Can monetary policy moves made as they are in Germany today, using monetary aggregates as intermediate targets, succeed in Euro area as well? Which monetary aggregates will be used? What of the money demand function? Will there be a real and reliable data base obtained by collecting and harmonizing data from within the Union?

Inflation targeting and conducting monetary policy in light of the target has been the normal procedure for many countries. Nonetheless there are lingering suspicions in some quarters about the credibility and reliability of this system, and since there is good chance that a loss of credibility will follow a failure to meet an inflation target, the ECB will not announce such a target. I should also mention that some member countries' central banks have reservations about conducting monetary policy with inflation targeting. People who accept monetary aggregates as good intermediate

targets say that in accordance with the principles of continuity and flexibility, which are the basis for central bank credibility, it is more realistic to target monetary indicators and use these targets to attain price stability.

For myself, I believe that central banks can control these monetary indicators and are responsible for them. If a central bank is assigned a task, it must have control over its instruments and operations and enjoy independence in the conduct of monetary policy to perform efficiently. This means that a central bank that has control over monetary indicators should use these indicators as intermediate targets in reaching its final inflation target.

On the other hand, in low inflation environments we have seen how successful the implementation of monetary policy under inflation targeting can be.

The ECB will follow both procedures together, in accordance with the principles of independence, transparency, a forward-looking policy orientation, and accountability. The ECB's credibility will grow. It will solve the problems that will arise and correct its operational deficiencies. It will strive to attain and maintain price stability. Achievement of this objective in the medium term will create conditions conducive to sustainable growth. Growth and employment will follow a sound path.

I see it at this stage as a perfectly designed set of strategies and applications.