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The Eurosystem and its Prospects - History in the Making

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CONTENTS:

1 Introduction

Ladies and gentlemen

It is both a privilege and a pleasure to host this year's annual conference of the European Association for Banking and Financial History. I am particularly pleased that this morning is dedicated to the forthcoming 10th anniversary of the Eurosystem. Almost exactly 10 years ago, on 1 June 1998, the ECB, and with it the Eurosystem, came into existence. Its inception heralded European Monetary Union (EMU), which was going to start seven months later and which has undoubtedly become one of the major success stories of European integration.

In 1998, however, the kick-off of the Eurosystem was regarded not only with curiosity and optimism, but also with concern and scepticism. On the one hand, pessimists predicted that the euro would be short-lived. They did not want to part with their respective national currencies, which – as in the case of the D-Mark – had often evolved into a symbol of national identity. On the other hand, the euro's proponents believed that the single currency would become a major catalyst for structural reform, thereby significantly boosting economic growth in the euro area. Today, with the benefit of hindsight, we know that neither excessive pessimism nor exuberant optimism was justified.

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Nonetheless, the Eurosystem has delivered a remarkable performance over its first decade. Against this backdrop, I would like to offer some thoughts on the first ten years of the Eurosystem and, looking ahead, discuss the challenges it faces in the future.

2 A stock-take: The Eurosystem's successes

Let me begin by taking stock of the Eurosystem's successes. For the EU as a whole, the euro represents a milestone on the road to further economic integration. During the past ten years, four more countries have joined EMU, while other countries are preparing themselves for accession. This can be seen as evidence of the single currency's role as a focal point of European integration.

According to various empirical studies, the single currency has stimulated trade between EMU member countries by raising price transparency and eliminating currency risk. Moreover, the euro has spurred the integration of financial markets in the euro area. This is most visible in areas that are closely related to the single monetary policy, particularly in money markets.

But most importantly, the Eurosystem has lived up to expectations concerning price stability. From the very beginning of EMU, financial markets and the general public have had faith in the Eurosystem's determination and ability to deliver price stability. That is true despite a series of substantial upside price shocks that the Eurosystem has faced over the past decade, ranging from high and rising oil prices to food price hikes and a continuous increase in administered prices and indirect taxes. For a young institution that started without a track record, the firm anchoring of longer-term inflation expectations is a huge success.

Recently, however, there seems to have been growing apprehension that inflation expectations in the euro area are on the rise. But a closer look at the data reveals that this is only true for short-term inflation expectations. That they have risen to values close to 3% for 2008 is hardly surprising in the

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wake of the recent hikes in energy and food prices. Note, however, that market participants and the general public are likely to readjust their short-term inflation expectations as soon as they observe inflation returning to a lower level. By contrast, medium to longer-term inflation expectations as derived from surveys and inflation-linked bonds have increased only slightly and remain close to 2%, which is broadly in line with our definition of price stability. The fact that the rise in longer-term inflation expectations is only marginal compared to the substantial temporary increase in the current HICP rate shows that the single monetary policy remains credible.

Longer-term inflation expectations are not alone in having stayed near the 2% norm. Since the inception of the euro, annual inflation in the euro area has, on average, remained in the close vicinity of 2% (at 2.07% to be precise), which is broadly in line with and only marginally above the Eurosystem's benchmark for price stability. In this context, it is worth stressing that, on the one hand, inflation rates within the euro area have converged at the lowest, not the average inflation rate prevailing prior to the inception of EMU. Hence, the level of euro area inflation is much more favourable than predicted by euro sceptics.

On the other hand, it is fair to acknowledge that although the level of inflation in the euro area is low from a historical perspective, this favourable development is not unique to the Eurosystem. In fact, a decline in trend inflation can be observed all over the world. Some critics argue that the low-inflation environment in the euro area must be attributed to the tailwinds of globalisation. To their minds, increased trade with labour-abundant economies has helped the Eurosystem to curb inflation.

However, I have always been fairly sceptical about this globalisation story. In my view, it does not adequately capture the most important aspects in explaining the decline in inflation rates, at least for the euro area. Rather, the advances in monetary policy that have been achieved in many countries over the past few decades appear to be the major driving force behind this decline. This is

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particularly true of the euro area, where the unique project of EMU constituted a special incentive to design a state-of-the-art institutional framework for a stability-oriented monetary policy. It is monetary policy which, over the medium to long term, pins down trend inflation. This explains why the global shift towards a new monetary policy paradigm has been so effective. The tailwinds of globalisation, by contrast, mainly affect relative prices – and therefore do not necessarily ultimately influence the aggregate price level.

At the current juncture, the tailwinds of globalisation have turned into headwinds, anyway. The recent surges in energy and food prices have driven the HICP in the euro area markedly above the Eurosystem's 2% stability threshold. These surges represent the latest – and arguably the most worrying – disturbance in a series of substantial upside price shocks the Eurosystem has faced over the past decade. As a consequence of various adverse price shocks, euro area inflation has, in the past 10 years, sometimes risen to levels above that which the Eurosystem considers consistent with conditions of price stability.

Against this backdrop, some critics have concluded that the Eurosystem should increase the level of inflation that it deems consistent with price stability. But it is important to understand that temporary episodes of elevated prices are by no means a justification for calling into question the Eurosystem's definition of price stability in the euro area. Changing the stability norm without necessity is bound to put the Eurosystem's credibility at risk. And, as is generally accepted, credibility is one of the most valuable assets of a stability-oriented monetary policy.

Our definition of price stability (ie inflation rates below, but close to 2%) is part of the Eurosystem's institutional framework. It has been very successful in providing guidance to the public and financial markets in forming expectations of future price developments. Such a clear and measurable yardstick is necessary as monetary policy can affect price developments only with significant time

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lags. Hence, I see no compelling reason why a temporary – albeit protracted – rise in energy and food prices should give rise to a discretionary change in the Eurosystem's stability norm. To the contrary. It would risk unanchoring inflation expectations at a point in time where their solid anchoring is of the essence.

Thus, the present price hikes are a timely reminder that, when it comes to inflation, complacency is out of place. We cannot rest on our laurels where credibility is concerned. It has to be proved on a daily basis. Over the past decade, the Eurosystem has shown that – if necessary – it is prepared to act in a firm and timely manner. We will continue to do so over the next decades in order to maintain price stability in the euro area over the medium term.

Another issue often put forward in the context of the Eurosystem's definition of price stability is that a single monetary policy aimed at a euro area-wide inflation rate of below, but close to 2% is too restrictive for catching-up member countries. Closely connected with this argument is the misapprehension that a one-size-fits-all monetary policy does not suit an economic area where business cycles have not yet fully converged. The idea behind this is that the single monetary policy would be too loose for buoyant economies and too tight for sluggish economies.

I do not share these views. While it is true that, when it was launched, EMU was not an optimum currency area as defined in the literature, the degree of business cycle synchronisation across euro area countries has increased since the beginning of the 1990s. In addition, the current differences in output growth across euro area countries are not large by either historical standards or by comparison with other large currency areas – such as the USA. This demonstrates that such differentials are a normal feature of monetary unions, not a cause for concern. What is striking, though, is that some euro area countries have, since the early 1990s, continuously over- or

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underperformed the euro area average in terms of real GDP growth. Consequently, the root of the problem does not lie with the existence of differentials in output growth, but with their persistence.

Part of this persistence can be attributed to catching-up processes in lower-income member states. Above all, however, the persistence suggests that in the single currency area shocks have a relatively long-lasting output impact, as the remaining country-specific adjustment mechanisms function slowly, largely reflecting structural rigidities.

Structural reforms, in particular the further flexibilisation of national labour and product markets, are the most suitable measure to overcome trend growth differences. Several EMU member states, including Germany, have demonstrated that labour market reforms and wage moderation can lead to a substantial reduction in structural unemployment rates. However, more progress is needed in order to further improve labour productivity, labour supply incentives and economic flexibility in the euro area. Likewise, the further integration and development of euro area financial markets can also help to absorb country-specific shocks more smoothly. The more diversified the sources of national income and the easier it is to borrow abroad, the less consumption and investment need to follow fluctuations in national output.

It would be desirable for national policy makers to further recognise their shared responsibility for ensuring a smooth functioning of EMU. Open and flexible economies create the best conditions to exploit the substantial benefits of the single currency. As a welcome side-effect, structural reforms would also facilitate the conduct of monetary policy. Although one monetary policy size must fit all in the euro area, reducing structural rigidities would, therefore, speed up the transmission of interest rate changes to prices, for example.

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3 The building blocks of the Eurosystem

Now, what are the determinants of the Eurosystem's success? Why did a currency area with no track record of its own attain such a high degree of credibility in so short a time?

As I have already indicated, the bulk of confidence in the fledgling European single currency was generated by the Eurosystem's institutional framework, which encompasses its independence, its mandate and its monetary policy strategy, plus an institutional framework geared at commanding the support of equally stability-oriented fiscal policies, as embedded in the Stability and Growth Pact (SGP). Key elements of this institutional framework have been transferred to the Eurosystem from the national central banks (NCBs), including the Deutsche Bundesbank. Consequently, with the transfer of parts of the NCBs' structure and ethos, the reputation of the currencies that were stable prior to EMU has lived on in the euro.

3.1 The Eurosystem's independence

Let me start my discussion of the Eurosystem's institutional framework with monetary policy independence, as it ranks among the most important elements of the euro's success.

First and foremost, central bank independence is not an end in itself. On the contrary, economic theory and empirical research find strong evidence that central bank independence is a precondition for achieving and maintaining price stability. It is precisely for this reason that central bank independence has emerged as a building block of central bank design in the 20th century. The rationale behind central bank independence is that it insulates central bankers from often short-term oriented political influence and ensures that monetary policy can concentrate fully on its medium-term stability objective.

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The Eurosystem's independence is laid down in the Treaty establishing the European Community and is, therefore, very well protected. Any amendment to the Treaty requires a unanimous decision by all EU member states. Moreover, it should be kept in mind that the Eurosystem's multi-dimensional independence has been an important signal to the general public and to financial markets. It has therefore contributed significantly to generating credibility right from the very beginning of EMU.

Nonetheless, some politicians cannot resist calling into question the Eurosystem's independence. Apparently, in an era of historically low inflation rates, the damaging effects of inflation are easily forgotten. Against this backdrop, it is reassuring that in the latest survey carried out by the Eurosystem 79% of our fellow citizens considered central bank independence important for the maintenance of price stability in the euro area. Especially in periods in which inflation rates are temporarily at elevated levels, such firm public backing is indispensable for a sustained culture of low inflation.

3.2 The Eurosystem's monetary policy framework

Besides central bank independence, the Treaty stipulates that maintaining price stability is the primary objective of the Eurosystem. This establishes a hard and fast hierarchy of objectives for the Eurosystem as well as clearly allocated responsibilities among EU institutions. Nowadays, there is a broad consensus that monetary policy can affect real activity only in the shorter term, albeit with variable and highly uncertain time lags. In the longer run, a central bank's influence is limited to influencing the price level in the economy. Therefore, ensuring price stability is the most important contribution monetary policy can make to achieving a favourable economic environment and a high level of employment.

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To fulfil its mandate, the Eurosystem has adopted a stability-oriented strategy, which comprises a quantitative definition of price stability and an analytical framework based on two-pillars: economic and monetary analysis. This specific approach attaches particular importance to robustness, ie to reflecting the complex environment of the Eurosystem. First, it ensures that no relevant information is overlooked when determining the nature and the extent of risks to price stability in the euro area. Second, it imposes a clear structure on the policy-making process. Third, it provides a communication framework that is as frank and as transparent as reality allows for. Robustness was especially important at the launch of EMU, when uncertainty about structural breaks in economic relationships and regularities was unusually high. In addition, at that time, the freshly harmonised time series and euro area-wide models had not yet been put to a practical test.

Apart from these considerable benefits, a possible drawback of a robust monetary policy strategy (as opposed to one-dimensional ones such as inflation targeting) might be that it appears more complicated to outsiders. In particular, it requires a greater willingness to look into the strategy's individual components and their interplay. After almost a decade of EMU, there are still critics who argue that the monetary pillar is nothing but a pro forma bequest from the Bundesbank to the Eurosystem, deemed to transfer credibility, but without any justification in its own right. The fact that broad money, M3, has been growing dynamically since 2004 in particular – without leaving a distinctive mark on the euro area's inflation performance for quite some time – has not helped to convince these critics otherwise.

However, their perception is wrong. The fact that the Eurosystem's monetary analysis is multi-dimensional is often overlooked. We do not focus on the development of a single indicator, M3, but look closely at all counterparts and components of money growth, analyse money demand models and use money-based indicator tools.

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More and more central banks, including those following an inflation targeting approach, recognise the information content of some sort of monetary analysis as a valuable ingredient of monetary policy. As for the Eurosystem, the distinctive elements of our strategy, namely the monitoring of credit and monetary developments, the longer-term view of monetary analysis and the process of cross-checking have stood the test during the recent up and down in financial and property markets. The insights gained from the interplay of the two pillars have strengthened our understanding of how financial imbalances emerge and have helped us to better identify macroeconomic developments in a forward-looking manner.

In a nutshell: the Eurosystem's two-pillar strategy has proven to be an adequate, relevant and efficient framework that can react flexibly to changes in the economic environment.

3.3 The importance of a stability-oriented fiscal policy

The institutional framework I have outlined so far – central bank independence and a stability-oriented monetary policy strategy – are necessary, though by no means sufficient, prerequisites for delivering price stability in the longer term. For a stability-oriented monetary policy to be successful in the long run, it has to be flanked by an equally stability-oriented fiscal policy. Unsound fiscal policies, with large budget deficits and mounting public debt, generally entail the risk of a conflict of interest between monetary and budget policies. This is particularly relevant in a monetary union in which the stability costs of government debt and deficits have to be borne by all member states.

In order to reduce possible political pressure on the Eurosystem, fiscal rules are laid down in the Treaty and operationalised in the Stability and Growth Pact. These rules require that all EU member states run public budgets close to balance or in surplus, measured through an entire economic cycle. However, the experience of the past decade demonstrates that fiscal discipline has not adhered to these standards in all EMU countries. First, during the economic downturn of 2001-2003, it became

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evident that the Pact does not go far enough in ensuring strict implementation and I am rather sceptical that the Pact's reform in 2005 has really solved this problem of implementation. Second, not all member states have used the economically good times since 2005 in order to achieve a balanced budget. As a consequence, these countries now have little or no room for manoeuvre in the event of an economic downturn.

Sound fiscal policies will remain a priority for many years to come. As demographic developments in Europe will place a considerable burden on social security systems, the sustainability of public finances is not only in the interest of the Eurosystem, but also of the euro area as a whole. In order to limit the negative effects on public and financial market confidence, it is imperative that the Pact's preventive arm is strengthened to ensure that the goal of attaining structurally balanced budgets in the medium term is achieved and safeguarded – also and especially in the large EMU countries.

Fiscal discipline is a very decisive pre-requisite for EMU to remain on a successful course for the coming decades. In this respect, too, the EMU member states have an important function as role models for those countries which have not yet joined.

Unfortunately, not all European politicians and governments in the euro area have in the last 10 years lent support to EMU by delivering fiscal discipline and structural reforms at home in order to foster the flexibility and thereby the growth potential of their economies. This should not be underestimated as a source of future conflicts and as a potential danger for the welfare of the monetary union.

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4 Concluding remarks

Ladies and gentlemen, in my speech I have explained that the Eurosystem's work has borne fruit. The single currency has made a noticeable contribution to improving growth prospects in the euro area, both by safeguarding price stability and by supporting economic integration among member states. We will do our utmost to ensure this success story continues. Both the Eurosystem and the euro had quite a good start, but all policy-makers have to work hard and stay firm on the chosen stability-oriented course in order to be able to cope with likely challenges and uncertainties in the future.

Thank you for your attention.

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