EUROPEAN CENTRAL BANK

"CONSIDERATIONS ON MONETARY POLICY STRATEGIES FOR ACCESSION COUNTRIES"

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Check against delivery.

It is a pleasure for me to deliver the key-note speech for this seminar on "Monetary Policy Strategies for Accession Countries", jointly organised by the National Bank of Hungary, the Institute for World Economics of the Hungarian Academy of Sciences and the Center for European Integration Studies of the University of Bonn. Let me congratulate the organizers for choosing a topic that is of particular relevance for the enlargement process.

I would like to start by reminding us all of the difficulties that central banks in accession countries face when taking monetary policy decisions. Their biggest challenge today – uncertainty – is also the main challenge the ECB faced at its establishment. In my remarks, I will discuss the implications of uncertainty for the design of monetary policy. I will also highlight some desirable principles for a monetary policy strategy aimed at achieving price stability in economies characterised by structural reforms, rapid growth, developing financial markets and vulnerability to external factors. A main conclusion I will draw is that monetary policy is effective in fostering welfare only if complemented by a sound macroeconomic environment and by an efficient microeconomic structure.

Monetary policy under uncertainty

The difficulties of policy-making under uncertainty are well known to all central banks. They have nonetheless been a particular challenge for the ECB at its establishment, due to the new and rapidly changing environment induced by the creation of Economic and Monetary Union (EMU). During the initial phase of EMU, it was particularly important for the ECB to ensure effective policy actions and to foster credibility in an environment characterised by pervasive uncertainty. The choice of the ECB monetary policy strategy was helpful in this respect. On the one hand, the strategy ensures effective policy actions by allowing the ECB to base its decisions upon a sufficiently large information set. On the other hand, it fosters credibility by avoiding pure discretion. Indeed, the ECB strategy provides commitment to a medium-term objective – price stability – and a structural framework to analyse the changing environment and to take monetary policy decisions that are consistent with this objective.

In order to reduce discretion and to enhance credibility, academics often recommend central banks to commit to *monetary policy rules*. In its strict formulation, a monetary policy rule prescribes how the policy instrument should be set as a function of a limited number of variables. Some proponents suggest the use of simple rules. These include unconditional rules (such as constant money growth rules) and conditional rules (such as McCallum base-money and Taylor

interest rate rules). One main criticism of simple rules is that the information set upon which monetary policy decisions have to be taken is too narrow. Consequently, other proponents have suggested the use of optimising rules, which allow the central bank to react to a larger information set. The popular inflation targeting adopted by a number of countries in recent years finds a theoretical formulation within this approach. The reaction of the policy instrument is derived optimally over time, starting from a given objective of the central bank and a simple "model" of the economy.

In my view, the presence of uncertainty severely limits the usefulness of simple and fully specified reaction functions for guiding monetary policy decisions. One reason is that policymakers face a very limited knowledge of the precise structure of the economy (the 'model' and its parameters). Therefore, they also imperfectly observe the channels of monetary policy transmission at work and the precise lags at which monetary policy impulses are transmitted to the economy. This limited knowledge constrains the ability of policymakers to derive optimising rules within a given model and it emphasises the need to complement the criterion of optimality with that of robustness to alternative model specifications. This uncertainty also reduces the desirability of rules that prescribe the central bank to reach its target at fixed horizons, as this may require undertaking costly counteracting actions later on.

A further reason why rules may not perform well in uncertain environments is that central banks imperfectly observe the state of the economy, the realisation of current and future shocks and their underlying nature (whether affecting demand or supply, and whether being transitory or long lasting). It becomes then difficult to correctly represent future inflation at a given horizon with the model-based inflation forecast, as required by the theoretical inflation targeting approach. An imperfect knowledge of the state of the economy also affects the performance of simple conditional rules, such as the Taylor rule. Variables appearing in these rules – such as the output gap and the equilibrium real interest rate – can only be estimated with high uncertainty. Recent academic literature has shown that sizeable and persistent measurement errors arise in estimates of these indicators based on real-time data, and that such errors typically lead to a significant deterioration of the performance of simple conditional rules.

In complex and uncertain environments, a mechanical use of rules is too restrictive to approximate the optimal policy. This should not lead to the conclusion that monetary policy should be purely discretionary. In economies where the lags of monetary transmission are long

and uncertain, discretionary policy actions can exacerbate economic fluctuations and postpone the achievement of the central bank's objective. Moreover, monetary policy needs to behave in a predictable and systematic way in order to stabilise expectations and to increase the effectiveness of policy actions. For these reasons, the ECB has committed itself to a monetary policy strategy.

A *monetary policy strategy* provides a systematic framework for the analysis of information and a set of procedures designed to achieve the central bank's main objective. As such, it differs from the strict formulation of a rule because it is contingent on all relevant information and it does not have a simple analytical representation. Committing to a strategy is particularly appropriate when the central bank has limited knowledge of the structure of the economy and when structural changes occur frequently. Indeed, a strategy should allow policymakers to take into account all relevant information and to translate it into effective policy actions.

The ECB monetary policy strategy: does one size fit all?

Let me now turn to the characterising elements of the *ECB monetary policy strategy*. This latter specifies how information is systematically organised and translated into policy actions aimed at achieving price stability – the ECB primary objective as stipulated in Article 105 of the EU Treaty. I would like to briefly describe the main features of the strategy and to discuss how they enhance the performance of the ECB monetary policy under uncertainty.

One important element of the ECB strategy is the definition of *price stability* as an annual increase in the Harmonised Index of Consumer Prices (HICP) in the euro area of below 2%. By providing a clear benchmark against which to evaluate the performance of the ECB, this definition promotes transparency and accountability of its monetary policy decisions. It also facilitates the achievement of high credibility – although this latter will be determined in the end by the ECB own performance. It might be surprising to find a definition of price stability as part of the ECB strategy.[1] The objective of price stability and its overriding nature is the core of the mandate of the ECB. It is enshrined in the Treaty and as such it cannot be subject to revisions at the initiative of the Governing Council. However, when devising its monetary policy strategy the ECB recognised that a quantitative definition of price stability was useful as a yardstick for accountability and as an anchor to inflation expectations – particularly for a new institution without track record.

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[1] See: Issing, O., Gaspar, V., Angeloni, I., and Tristani, O., *Monetary Policy in the Euro Area*, Cambridge 2001, Chapter 4.

To reflect the long and uncertain lags of monetary policy transmission, the strategy adopts a *medium-term orientation*. Recent research by Eurosystem economists has confirmed that relevant lags in the transmission of monetary policy impulses in the euro area are two years or longer. Therefore, policy decisions need to be taken in a forward-looking and pre-emptive way. The medium-term orientation also allows for measured responses to unforeseen shocks, thus avoiding the introduction of unnecessary volatility in output, employment and interest rates. Furthermore, the ECB commitment to achieve and maintain low inflation over the medium term ensures credibility of future policy intentions. By anchoring the private sector expectations of future variables, this allows to maximise the benefits of price stability.

The strategy's diversified approach based on *two-pillars* provides robustness to model and parameters uncertainty. This approach ensures that all elements in the ECB's information set are taken into account and organised in a coherent way when taking monetary policy decisions. The first pillar assigns a prominent role to money, recognising the stable relationship between money and prices in the euro area and the fundamental monetary nature of inflation in the long run. The second pillar complements the analysis of money with a broad assessment of non-monetary indicators. Both pillars provide input into policy decisions aimed at price stability. Therefore, the two-pillar strategy ensures that the analysis produced under each of the two perspectives is confronted and cross-checked.

Today, central banks in accession countries face a challenge similar – if not greater – to the one faced by the ECB at its establishment, as their convergence process contributes to create an uncertain and rapidly changing environment. In this context, it is worthwile to recall that despite all the potential uncertainty the start of EMU became reality after many years of preparation – one might say even decades – and after a gradual process of economic convergence towards stability in Western Europe. This provided the necessary basis for the successful launch of the monetary policy of the ECB. Just as the ECB did not start out of the blue, accession countries need not leap in the dark. In this respect, the ECB monetary policy framework and its implementation provides a valuable benchmark and an anchor for the end point of the accession countries own paths to convergence and stability. Several elements characterising the ECB monetary policy strategy could already now be useful for accession countries. Nonetheless, any general guideline for the design of a monetary policy framework needs to be tailored to country-specific considerations. For instance, the one-to-one relationship between money and prices in

the long run has been found to be empirically robust across countries, periods and policy regimes, as well as across estimation methodologies and definitions of the monetary aggregate. Therefore, any strategy aimed at price stability must monitor long term monetary developments. However, the precise role of money in a strategy over a shorter horizon should reflect country-specific considerations. Accession countries are small open economies and, as such, they are vulnerable to international factors. In particular, they are exposed to capital flows, which are a potential source of high volatility in domestic monetary and credit aggregates. Moreover, the presence of recurrent structural changes in the financial sector of accession countries may induce instability of the money demand along the convergence process.

Before discussing monetary policy strategy issues for accession countries, I would like to delineate some contours within which the choice of a suitable strategy can be made. I will first identify some general pre-requisites for any successful monetary policy strategy. Some relate to the strategy itself, others to the prevailing institutional arrangements and others to the underlying macroeconomic environment or microeconomic structure. I will then point to additional pre-requisites, which need to be satisfied by central banks aiming at price stability in accession countries.

Pre-requisites for a successful monetary policy strategy

The first general pre-requisite for a successful strategy is the existence of a clear objective to be achieved by the monetary authorities. There is widespread consensus today on the importance of *price stability*. Through its achievement, monetary policy can make its best contribution to economic growth and prosperity by reducing the social cost of holding money, by allowing for an efficient adjustment of relative prices and by maintaining low risk premia on interest rates.

It is therefore important that institutional arrangements provide central banks with *a clear mandate* to achieve price stability. This ensures commitment of the central bank in pursuing its main objective, thus enhancing credibility.

A key additional pre-requisite is *central bank independence*. This institutional feature isolates the central bank from political pressures and it ensures that monetary policy actions are taken with the unique scope to pursue the central bank's mandate. Only a central bank that is mandated to refuse to fund budget deficits by money creation can be credibly committed to the achievement of stable prices over the medium term.

The assignment of an important public policy to an independent institution needs to be accompanied by *transparent and accountable* policy design and implementation. By enhancing central bank discipline and communication with the public, transparency and accountability help to improve credibility and to generate low inflation expectations.

It is also crucial that the achievement of price stability is supported by sound *fiscal policies* because this enhances the credibility of the goal of price stability and helps maintain low inflation expectations. Irresponsible fiscal policies can jeopardise credibility, as higher inflation becomes desirable to reduce the real value of government debt.

Accession countries should ensure that these general pre-requisites are satisfied. Indeed, some of these requirements will have to be met for membership in EU. Article 4 of the EU Treaty states that the activities of EU member states should entail compliance with the guiding principle of stable prices. The Treaty also foresees an assessment of each EU member state's convergence process that comprises an examination of its national legislation, including the statute of its national central bank. An important point of this examination relates to the independence of member states' central banks.

The successful implementation of a monetary policy strategy in accession countries requires that additional pre-requisites be satisfied. The most important is for central banks to achieve and *maintain high credibility of the disinflation process*. Several accession countries have made remarkable progress in reducing inflation over the last years. To be able to continue this process until the achievement of price stability, central banks need to preserve their credibility. By ensuring that low inflation expectations become entrenched, credibility contributes to achieving and to maintaining price stability. In fact, low inflation expectations have a beneficial effect on economic decisions that are relevant for inflation developments, such as wage and price setting.

It is also crucial that accession countries implement structural reforms to facilitate the *smooth functioning of goods, labor and capital markets*. When goods and labor markets are rigid, inflation and inflation expectations may remain high even in the presence of monetary regimes committed to the achievement of price stability. The existence of liquid and well-functioning capital markets is also important, as it allows for an efficient conduct of monetary policy through the use of market-based instruments.

A further requisite for a successful strategy in accession countries is *consistency with the ongoing process of nominal and real convergence*. Monetary and exchange rate policies should aim at generating a stable environment that enables to anchor expectations while providing enough flexibility to allow for adjustments in the case of unforeseen shocks.

To ensure such a stable environment, it is important to create a sound institutional setting for *regulation and supervision of the financial sector*. An inadequate structure of public incentives for the corporate and banking sector may induce to overlook economic risk, leading to low profitable investments and to insufficiently performing bank loans. In economies exposed to external shocks and large capital flows, this may add to the financial vulnerability and increase the probability of occurrence of a currency crisis.

What monetary policy strategy after EU accession?

The question to answer at this point is what monetary policy strategy is suitable for accession countries after EU accession. It is impossible to envisage one strategy that shares the same elements across countries and over time. Some elements are common – such as the desirability of price stability. Other elements depend on specific features – such as the appropriate choice of the exchange rate regime. For instance, fixed exchange rates may be appropriate during the initial phase of a disinflation process for small open economies with little rigidities in goods and labour markets and with an economic structure similar to the one of the anchor country. Under such circumstances, wage and price flexibility can be used as a substitute for exchange rate flexibility to absorb the shocks hitting the economy, while a common economic structure limits the probability of frequent asymmetric shocks.

At present, monetary policy strategies in accession countries diverge considerably. The exchange rate regimes vary from completely fixed arrangements to pure floats. In the early stages of the transition process, most accession countries have relied on pegging the exchange rate to a highly stable currency, as a way to import credibility from abroad and to reduce the inflation rate from high levels. Since the mid-1990s, a number of countries have gradually softened their pegs and moved towards a greater role for monetary policy. Several among them have adopted inflation targeting as a monetary policy framework. The overall success in anchoring expectations and in reducing inflation suggests that alternative strategies can be adopted. Nonetheless, it is important to ensure that current strategies are able to maintain a credible disinflation process and to achieve price stability consistent with a sustainable process of nominal and real convergence. Therefore,

the assessment of alternative strategies needs to take into account two characterising features of the convergence process in accession countries, namely the trend appreciation of the real exchange rate and the exposure to large capital flows.

Over the recent past, most accession countries have experienced an *appreciation of the real exchange rate*. Several factors can explain this real appreciation as an equilibrium phenomenon. One common explanation relies on the higher productivity growth experienced for tradables than for non-tradables in fast growing economies (the so-called Balassa-Samuelson effect). When labour is mobile domestically and the law of one-price holds, high productivity growth for tradables increases the overall level of real wages and the relative price of non-tradables to tradables. If the productivity growth differential with the euro area is larger for tradables than for non-tradables, the price level of accession countries increases relative to that of the euro area, inducing a real exchange rate appreciation. Other features of the convergence process in accession countries can generate an equilibrium appreciation – such as the increasing demand of non-tradables relative to tradables along the transition path and the capital inflows induced by initial disparities in capital to labor ratios.

Accession countries have also experienced large and volatile *capital flows*, which expose them to the risk of sudden speculative attacks. The size of accession countries is small relative to the global capital markets. Minor shifts in international portfolio allocations can have large effects on the amount of capital flows directed to these countries and thus on their economic conditions. The presence of high capital mobility and pegged exchange rates has often been regarded in the literature as the main cause of the financial crises experienced in emerging markets during the 1990s. A large initial capital inflow may induce booms and generate large current account deficits. If, for any reasons, capital flows reverse, this may lead to increases in the degree of country risk, further capital outflows and pressures on the exchange rate up to the point where the peg has to be abandoned.

Provided that a *hard peg* ensures credibility, this exchange rate regime will limit the risk of speculative attacks. This choice can also be useful to steer inflation expectations and thus to reduce inflation. However, the presence of a fixed exchange rate inevitably shifts the burden of international relative price adjustments towards domestic prices. This can potentially endanger the convergence to the euro area inflation rate and the achievement of price stability, although this would require large and persistent shifts in relative prices.

A regime of *flexible exchange rates* offers some protection against speculative attacks while providing ample room to accommodate the adjustment in relative prices through an appreciation of the nominal exchange rate. To anchor inflation expectations, this regime requires that monetary policy is credibly committed to achieve low inflation. The choice of many accession countries to combine flexible exchange rates with inflation targeting may reflect this need. It is important that each country decides its inflation targets in accordance with the degree of sustainable convergence already achieved. For economies currently experiencing higher inflation rates, it may be appropriate to pre-announce a disinflation path as a way to steer inflation expectations and wage developments. However, the credibility of such pre-announcements would require that disinflation would not be artificially supported by short-term developments in indirect taxes or administrative prices. For countries already experiencing low rates of inflation, it may be appropriate to consider the definition of price stability adopted by the ECB as a benchmark against which to set their own inflation targets.

The alternative choice for accession countries is to adopt an *intermediate exchange rate regime* such as ERM II. Intermediate regimes provide some anchor to expectations, while countries retain the flexibility to adjust the parity in case of asymmetric shocks and exchange rate pressures. The main difficulty with this option is that it leaves the country exposed to changing conditions in the global capital markets. It becomes then even more crucial for the monetary and fiscal authorities to credibly commit to stability-oriented policies.

An essential task of any monetary policy strategy after EU accession will be to guide the choice of the timing of entry in ERM II and later in EMU. EU accession does not necessarily imply immediate entry in ERM II, although this may be an option for some countries. It is important that any decision to join ERM II is consistent with an adequate level of nominal and real convergence with the euro area. This would reduce the risk of currency crises and of choosing an inappropriate parity for the exchange rate. Once in ERM II, countries will be expected to continue their convergence process until the sustainable achievement of the Maastricht criteria. ERM II could provide a suitable environment to accommodate this process. On the one hand, currency stability is ensured by the commitment of domestic policies to achieve price stability. On the other hand, the wide band of ±15% provides enough flexibility to accommodate necessary movements in relative prices.

The decision of the timing of adoption of the euro will also become part of the country's overall monetary policy framework. To adopt the euro, countries will have to satisfy the Maastricht criteria and the requisites for sustainable convergence. These include a minimum participation in ERM II of two years. The period necessary to satisfy the requirements, however, may vary considerably among countries. More importantly, the optimal timing of adoption of the euro from the perspective of each accession country may differ, depending on the structural and institutional features prevailing after the required two years in ERM II.

The adoption of the euro will benefit accession countries by reducing interest rate premia, real interest rates and the risk of speculative attacks. Nonetheless, for some countries the benefits of staying longer in ERM II could more than offset the opportunity costs. A longer stay would allow using some exchange rate flexibility to adapt remaining differences in productivity gains, wage growth and inflation relative to the euro area. Once adopted the euro, differences will translate in costly changes in competitiveness and in economic activity. Therefore, optimally choosing the timing of adoption of the euro also implies reducing the differences in per capita income levels.

Concluding remarks

To conclude, I think that central banks in accession countries can do a lot to facilitate a smooth and sustainable accession process. Their main contribution is to establish a framework for monetary and exchange rate policy that is at the same time stable and flexible. This can facilitate the achievement of a credible disinflation path and later the maintenance of price stability, in the respect of a sustainable process of nominal and real convergence.

Price stability and satisfying results for employment and growth can only be achieved if the central bank is not left alone. Monetary policy needs to be complemented by a sound macroeconomic environment and a well-functioning microeconomic structure. Achieving a stable and efficient environment may impose significant constraints to accession countries. Nonetheless, this effort is necessary for a sustainable convergence process and therefore for EU and EMU accession. We should not forget that the rewards in terms of economic activity and overall welfare for accession countries would be large and long lasting.