EUROPEAN CENTRAL BANK

Opening address

at the

International Research Forum: Third Conference

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Ladies and Gentlemen, Dear Governor Kohn,

It is a great pleasure to deliver the opening address for this third conference of the International Research Forum on Monetary Policy which is sponsored by the Federal Reserve Board, the Center for German and European Studies at Georgetown University, the Centre for Financial Studies at Goethe University here in Frankfurt and by the ECB.

I am especially pleased to welcome Governor Kohn here today, an esteemed colleague and member of the Board of Governors of the Federal Reserve System and of the FOMC. I should also welcome the representatives of the Center for German and European Studies and the Centre for Financial Studies, as well as all those who will present and discuss their findings and ideas at this conference. My thanks go to the organisers of this event, Ignazio Angeloni, Matt Canzoneri, Dale Henderson and Volker Wieland.

The goal of the International Research Forum is to foster the transatlantic dialogue by exchanging views and opinions about topics that are of relevance to monetary policymaking from a global perspective. The Forum was established in 2002 and its first conference was hosted by the ECB. As the leaflet circulated today shows, Axel Weber, current President of the Bundesbank, is one of the original organisers. The second conference was held in December 2003 at the Federal Reserve Board in Washington D.C., and it is now 'our turn' to host this transatlantic dialogue again. The exchange between the Federal Reserve Board and the ECB within the International Research Forum will continue on December 1-2, 2006 with the next Forum conference, hosted by the Federal Reserve Board.

While central bankers have many opportunities to discuss policy in various groups, the International Research Forum focuses on research. Instead of taking the form of a general discussion of key policy questions of the day, the topics at this Forum are addressed using formal analytical tools. To learn what such formal approaches can bring to the table, we invited academics as well as economists from international organisations and central banks from both sides of the Atlantic.

Sometimes the interaction between practitioners and theorists reminds me of the story involving a physicist having to deal with data and a mathematician trained in abstract reasoning. The physicist has worked out an empirical equation that seems to explain his data and asks the mathematician to have a look at it. After one week, the mathematician replies by saying that the equation is invalid. By then, however, the physicist has used his equation to predict the results of further experiments, and is getting excellent results. So he asks the mathematician to

have a second look. After another week, the mathematician tells the physicist that the equation does work, "But only in the trivial case where the numbers are real and positive."

To bridge the gap between theory and practice, Governor Gramlich in his opening address at the first Forum conference, back in 2002, has proposed a range of research areas that we central bankers find relevant from the perspective of practical policymaking. Topics mentioned at the time include, amongst others, more detailed studies of the dynamics of the inflation process, the role of fiscal policies in a currency union, the design of optimal monetary policies, and the scope for policy coordination in an uncertain world. Looking at the program of this conference suggests that considerable progress has been made along the lines suggested by Governor Gramlich. At the same time, many issues still remain to be explored and I will give you my view on some of these later on.

In today's and tomorrow's presentations, we will listen to

- theoretical and empirical studies investigating the institutional arrangements required for promoting credible monetary policies and for anchoring inflation expectations;
- studies analysing the conduct of monetary policy in the presence of learning and uncertainties about the structure and evolution of the economy;
- investigations taking explicitly into account the open economy dimension of monetary policy, including the international policy coordination in an uncertain world;
- analyses of the performance of monetary policy rules in structural equilibrium models of the business cycle that are sufficiently detailed to offer quantitatively credible descriptions of the data.

The conference papers make significant advances over the existing body of knowledge. Let me add, however, some remarks on where research, in my view, could still make useful contributions.

One first aspect that strikes me is that the majority of empirical academic research focuses on the U.S. economy. It seems that an important driving force behind this tendency is that most economic models tend to abstract from regime shifts in policy and other kinds of structural economic breaks and uncertainties. Arguably, the U.S. economy comes closest to this ideal world – at least it appears to be closer to it than the European countries for which the

transition to the Economic and Monetary Union may be considered as a significant and easily identifiable structural break, at least for some participating countries.

Structural breaks pose problems for economic models, which usually assume constancy of behaviour. However, this is a shortcoming of the models and not of the data. Indeed, precisely large and well-identifiable shifts in a policy regime can reveal a lot about the underlying economic structure and the economic forces at work.

My favourite example is the transition to Economic and Monetary Union (EMU). This transition represented a policy shift for some participating countries. At the same time, the question of whether agents would properly internalize this change in regime in their expectations was an issue of contention. The convergence towards Economic and Monetary Union in Europe in the second half of the 1990s thus offers a prime example illustrating how such a change in expectations to a new policy regime that needed to be as credible as the one of the most credible European currencies can be managed.

Let me provide you a brief account of what, in my view, were the main ingredients making this transition a success.

One of the important building blocks of success was the Maastricht Treaty, which came into force in November 1993. Its fundamental inspiration was the need to ensure that participants in EMU are like-minded in their pursuit of stability in economic and monetary affairs. It vested the European System of Central Banks with a very high degree of independence and safeguarded it against external interference. The new single monetary authority was to be indisputably devoted to one overriding objective, the maintenance of price stability in the euro area. In that respect, the Treaty embodied both the best monetary tradition available in Europe and the essence of the principles that had been distilled through years of academic reflection.

The Maastricht Treaty also specified convergence criteria to provide countries with yardsticks against which to measure their progress toward a true culture of stability in the run-up to Monetary Union. But the interpretation of the entry criteria remained a matter of debate for most of the years that followed the promulgation of the Treaty. Observers were divided. Some took the position that the Treaty's criteria were too strict and ambitious, given the initial conditions from which a number of member countries had to start convergence. Others, from the perspective of the most stable economies in the EU, were convinced that they granted considerable, in fact excessive, latitude.

The discussion between strictness and latitude left a margin of ambiguity, which largely affected the evolution of expectations prior to 1998. The perception that the criteria might be impossible to meet for countries too far off the benchmarks produced uncertainty about the number of countries able to participate in Monetary Union from the outset. In addition, the suspicion that the Maastricht criteria would tolerate a large dispersion of economic performances across countries produced expectations that Monetary Union – if it were ever to materialise – could mean convergence to the average, rather than the best, standards of macroeconomic discipline.

In 1996 and even more in 1997, the evidence of an ongoing break in market expectations became quite clear. The latter part of 1996 saw a determined drive toward fiscal consolidation in Italy and Spain. This facilitated in those countries a sharp fall in interest rate premia at long maturities and an easing in monetary conditions more generally. In June 1997, the Stability and Growth Pact was sealed in Amsterdam. It reassured the markets that the adjustment made in public finances in a large portion of the European Union would be lasting and would survive a country's adoption of the euro. By the first half of 1997 interest rate differentials had been compressed to levels not seen in decades. Uncertainty surrounding the breadth of Monetary Union at its starting date thus seemed to become less pervasive.

A measure of uncertainty, however, remained about the standards that would apply in the new economic and monetary entity. This source of uncertainty came to the surface in summer 1997, when the intermediate-maturity yields paid by those core countries which had reached complete alignment started to rise. The balance of market expectations seemed to be shifting toward a loose interpretation of the new regime; and the conviction was gaining ground that the rapid descent of short-term rates in the converging economies of Italy, Spain and Portugal would be matched by a gradual increase in the short-term rates of the low-yield economies. The two paths would meet somewhere half-way.

This shift in market expectations did not go unnoticed, especially in the Central Banks issuing the currencies that had already converged. Therefore, in October 1997, a pre-emptive interest rate increase took place to forestall the build-up of an inflationary potential in the delicate phase of transition to monetary union. This interest rate move was a strong sign of determination because signs of an upswing were still tentative and price strains were not yet fully in sight in this core currency area. The policy message was reinforced through a consistent communication campaign which the Central Banks concerned, together with the

European Monetary Institute, launched in the last few months of the year to explain the meaning of their action. The essence of the message was the following.

The assumption made by some observers and by part of the market literature, according to which the entry interest rates in the Euro on 1 January 1999 would be some kind of average of the interest rates of the composing currencies was totally wrong. On the contrary, the very construction of the Euro was based on total continuity with the most credible national currencies. The concept of the transition was based upon "benchmarking", namely convergence towards the best performers and not convergence towards a mean. The modest interest rate increase that took place in a small number of economies was designed exclusively to preserve monetary stability and stability of inflationary expectations for the currencies that were the benchmark for the Euro. The ECB itself, the soon to be born monetary authority, would be uncompromising in its role as guardian of price stability, in close continuity with its best predecessors. It was therefore fully justified that interest rate convergence inside the future Euro area would take place via convergence of the different yield curves of the various currencies towards the benchmark yield curve of the core currencies that had already converged.

How did markets react to the policy measures taken in the last quarter of 1997?

Following the October 1997 decision and the communication thereafter, the remaining spreads between the converging economies and the core countries progressively disappeared. Moreover, the benchmark yield curve itself was changing shape in a way that is consistent with a reduction in agents' inflationary expectations, possibly driven by a scaling back of the uncertainties regarding the conduct of monetary policy in the future currency area. Inflation expectations were thus anchored at a low level already at the birth of the new currency.

The transition to Economic and Monetary Union was without doubt a remarkable success. But credibility is never gained once and for all. It has to be permanently preserved and enhanced and this is the objective we are working for. I hope that the presentations and discussions that we will have here during the next two days will contribute to our understanding of monetary policymaking and thus contribute to our continued success. I wish you all a pleasant and exciting conference!