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# Monetary Policy in a Global Environment

**Remarks by Dr Sinikka Salo, Member of the Board of the Bank of Finland at the Seminar "Russia and Globalization", House of Estates, Helsinki, 1 October 2001**

Ladies and Gentlemen,

Let me begin by saying that I appreciate very much the opportunity to discuss monetary policy in front of this distinguished audience. I have been asked to consider monetary policy in the international context of globalisation, and this is certainly a timely subject these days. It is topical not only for central bankers and economists, but also to commercial bankers and businessmen.

We know from the experience of the last decade that currency markets and international finance have so powerful influences on our economies - in Finland, in Russia, and elsewhere too - that it would be quite impossible to understand economic developments without paying a lot of attention to international monetary forces.

However: if there is one area in the economy where globalisation is not new, this area must be monetary policy. For many decades already, no country with a convertible currency has been able to conduct monetary policy in isolation, as if the external world would not matter. For many small countries, the external factor has often meant that the balance of payments has been a more powerful determinant of monetary policy than domestic policy goals. For larger countries with floating currencies, the external factor has often meant that the exchange rate may have had a more powerful influence on the monetary conditions than the interest rate decisions of the central bank. In Finland, for instance, external considerations have had a very important influence on the monetary situation of the country at least since 1958, when the markka became a convertible currency, and we may even say that external factors took the dominant role after the early 1980's when short-term capital movements began to be liberalised.

In today's world, however, global financial markets are larger and more efficient than ever before. The nature of financial competition has also changed. In the past, financial markets were mostly about competition between banks, and between firms. Today, competition has a new dimension: monetary systems themselves are competing with each other, and this new competition is changing monetary policy and monetary systems of the world. Competition has forced a restructuring of central banking which to some extent resembles corporate restructuring often observed in private industries. And just as in industry, the effects of competition are ultimately healthy: the reforms which the new competition between monetary systems has prompted, are actually significant improvements on the practice of previous decades.

At the start of the Third Stage of the Economic and Monetary Union (EMU) in the beginning of 1999 Finland adopted the euro as its currency and the common euro area monetary policy as its monetary policy. In less than three months' time we will, with 11 other European countries, start circulating euro banknotes and coin. The creation of the monetary union and the birth of the euro can be seen as a response of the EU countries to the new financial environment they find themselves in. It is our solution to the problem how to organise the monetary affairs of this group of countries whose economies are highly integrated, in a world where financial markets constantly challenge each national currency and the institutions behind it.

Let me now briefly describe some of the challenges which globalisation has created for monetary policy. After that I will turn to consider how the European monetary union and its member central banks - including the Bank of Finland - are responding to these challenges in their common monetary policy for the euro. I will conclude with some remarks on the future of international monetary affairs.

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I have three interrelated challenges to monetary policy on my list.

The first and most obvious challenge I have already mentioned. It is the growing international interdependence of monetary conditions across the world. Because financial markets are now effectively integrated into a single global market, and because money flows with increasing speed from a financial centre to another, central banks cannot isolate their domestic economies from international monetary forces. However: this increased interdependence does not mean that monetary conditions are necessarily equal across the world, far from it. Where there is uncertainty about the future value of money, for example, or about the protection of investment, monetary conditions will be tighter than elsewhere, precisely because markets have become global: an this leads us to the second challenge on my list.

The second challenge is that information and credibility matter more than ever before. This is because real-time economic and political information flows much more efficiently than ever before, and is available to more people than before. The consequence of this is that markets react stronger than before to any available news, suspicions - and even rumours. Because of this development, uncertainty and lack of credibility have much more severe consequences than before. Monetary policy of central banks is no longer only about the management of interest rates or other policy instruments, it is about the management of expectations and maintaining the confidence and trust of the people who are holding and using money.

The third challenge on my list is the growing dependence of monetary policy on the so-called economic fundamentals. This also results from the worldwide development of more complete financial markets. Markets analyse long-term growth prospects of economies, they consider the long-term sustainability of governments' fiscal plans, and they are able to react to these analyses. These reactions have monetary consequences. As a result, central banks cannot create monetary stability if the so-called fundamentals of the government budget and the real economy are not in order. Even the best monetary institutions, no matter how well designed they are and no matter how well they are run in a technical sense, will not be able to achieve monetary stability if the necessary "real" preconditions are not in place. There are many examples of this, from the developed west and from the emerging markets, too.

Next I shall turn to the institutional framework of the monetary policy in the euro area.

When the economic and monetary union was created in Europe, a lot of emphasis was put on creating institutions which would guarantee a stability-oriented, consistent and credible monetary policy. Actually, however, this careful institutional design was not primarily done for the markets' sake. It reflected more the requirement of the joining member countries that when they would exchange their separate monetary policy for a common policy, they would know exactly what they were getting. They wanted to make sure that common monetary policy would generate durable monetary stability. This is the political reason why the Maastricht Treaty, which established the monetary union, is so strong about the institutional independence of the central banks, and so clear about the tasks for the monetary policy of the union. But, as a result of these requirements formulated by the joining members, an institutional structure was created which also gives a very good basis for credibility as required by the development of the markets.

Monetary policy for the European monetary union is decided by the European Central Bank in Frankfurt. Policy is implemented and executed by the 12 national central banks which - together with the ECB - constitute the Eurosystem. So, the implementation of monetary policy is mostly decentralised, although decision-making is centralised in Frankfurt. On the other hand, governors of the national central banks do participate in the decision-making since they are members of the Governing Council of the ECB. So, not only implementation but also the decision-making function is rooted in the national central banks of the member countries. This underscores the fact that the countries joining the EMU have actually not given up their monetary sovereignty, they have rather pooled it together. This structure with national representation also gives monetary policy – which is conducted for 300 million Europeans - the legitimacy which is a necessary condition for credibility.

The legal mandate of the European Central Bank is very clear. According to the statutes of the ECB, the primary objective of monetary policy is to maintain price stability, and other objectives can be taken into account only if they do not compromise the objective of price stability. All central banks of the Eurosystem are also legally independent of governments and other institutions, so they are protected from outside interference in pursuing their policy.

The law does not say what exactly is meant by price stability. However, it is very important for the credibility and predictability of ECB's monetary policy that people should know how ECB interprets its primary objective. If people were uncertain about what the ECB wants to achieve, this would add uncertainty in the markets and might jeopardize their trust in the value of the euro. For this reason, the Governing Council of the ECB has published its definition of price stability. According to this official definition of price stability, the rate of inflation in the euro area as a whole should be kept below 2 per cent over the medium term. In this definition, inflation is measured by the Harmonised Index of Consumer Prices (HICP), which is compiled by similar methods in all member countries.

In order to trust monetary policy, markets need to be able to monitor it on a daily basis. This means that markets need to know not only the goals of policy, but they also need to have adequate understanding of the strategy. Strategy should not be confused with policy objectives: strategy includes also a description of "how you are going to get there". Most central banks in the world have not been very explicit of their strategy. However, the European Central Bank published the main elements of its strategy already three years ago, that is before the euro was launched.

The ECB's monetary policy strategy consists of the definition of price stability and two so-called "pillars". These pillars are actually two categories of economic information and analysis, which are combined in the meetings of the Governing Council of the ECB when it takes monetary policy decisions.

The first of the two pillars is the analysis of the money supply in the economy. This is based on the fact that inflation is generally accompanied by excessive increase in the amount of money, and therefore monetary statistics contain information on the inflationary pressures in the economy. To give more content to this "first pillar", the ECB has also set a reference value, a kind of benchmark, for the growth of M3, which is one of the various measures of money. This reference value is currently 4½ per cent per year, and it is based on the general estimation that in the longer term, this rate of growth of the money supply would be consistent with the objective of price stability, i.e. inflation remaining below 2 % in the medium term. It should be noted that this value of 4½ % is , indeed, a reference value, not an intermediate monetary target. The ECB does not attempt to control M3 growth so as to reach the reference value at a specific point in time, but monitoring monetary growth is important because substantial or prolonged deviations of M3 growth from the reference value would, under normal circumstances, signal risks to price stability.

The second pillar is a forward-looking analysis of the macroeconomic situation in view of its implications for inflation. This analysis focuses on the balance of supply and demand in the goods and labour markets, as well as cost pressures emanating from import prices, etc. Under this second pillar, macroeconomic projections, kind of forecasts, are produced regularly by the staff of all central banks of the Eurosystem. These projections are estimates of how the economy would develop under unchanged monetary policy, and under other carefully specified assumptions. Since last year, the ECB has published these projections in its Monthly Bulletin.

Interested market participants and other ECB-watchers can see the two-pillar strategy at work by following the press releases and press conferences which are given once a month after the ECB Governing Council has met in Frankfurt. These press releases, as well as the introductory remarks of the President of the ECB in the press conference, as well as further analysis of the economic developments underlying the monetary policy decision provided in the ECB Monthly Bulletin (which is available a week after the first Governing Council meeting of each month) are always couched in terms of the two-pillar framework: they are presenting first the monetary situation ("first pillar"), and moving then to the analysis of the inflationary implications of the general macroeconomic situation, including cost and exchange rate developments ("second pillar").

I have gone through the objectives and strategy of the Eurosystem in some detail to underscore the great importance that we in the euro area attach to transparency and consistency. Actually, not many central banks are as explicit and open about their policy as the ECB is. Explicit targets, explicit strategy, published macroeconomic projections, regular press conferences, Monthly Bulletin: this amount of information and confidence-building would have seemed quite extreme, perhaps even unthinkable, to most central bankers only a decade ago, when "mystique", not transparency, still was the buzzword in monetary policy. The evolution has been striking, and positive, and I think that it has largely happened because of the process which is now called globalization.

But how has the Eurosystem succeeded in its attempt to establish a new, but credible international currency?

As you know, there has been some controversy about this question. The debate started mostly because during the first year and a half after the euro was born (until about a year ago) the common currency depreciated almost continuously against the US dollar. Some commentators took this as evidence that monetary policy had failed, and that the euro was not credible enough, despite all the efforts of the ECB.

This conclusion was not correct. First of all, the slide of the euro stopped about a year ago; after that, it has been trading in a rather narrow range. More seriously, it is very one-sided to judge the success of monetary policy by the level of the exchange rate. The euro is a floating currency, and so there is no exchange rate target. Therefore, the exchange rate is a market price, sometimes difficult to interpret, but it is not a good criterion of the success of ECB's monetary policy.

The criterion of success for the ECB's monetary policy is the degree of stability it has achieved in its home court, the countries constituting the euro area. There, the record must be seen as overwhelmingly positive.

First of all, the EMU has created a large currency area, so the uncertainties emanating from the currency markets matter less than before. Secondly, the exchange rates between the currencies of the member countries have been altogether eliminated, so this source of uncertainty has also disappeared.

Thirdly, and most importantly, there is evidence that the ECB has succeeded in stabilising inflation expectations. Inflation forecasts available from different independent sources suggest that price stability is expected to prevail in the euro area over the medium term. The relatively modest levels of euro denominated long-term interest rates point to the same conclusion.

Yet one indicator of the trust in the euro in the markets is the use of the new currency on international capital and money markets. Available statistics suggest that the euro has established itself firmly as the second most important currency used in the international financial markets, second only to the US dollar. In the first two years of the euro's existence, almost 40 per cent of international bond issues were denominated in euro. In international money markets, the use of the euro in short-term inter-bank lending and borrowing has been growing too.

In the end, however, the success of the euro as a currency will be conditional on the success of the general economic policy of the euro area countries. For the maintenance of monetary stability, it is important that the countries will continue to keep fiscal soundness as an absolute priority in their budgetary policies, and it is equally important that structural economic policy in the area succeeds in creating good preconditions for sustainable economic growth.

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Looking into the future, monetary policy must find its course in a very complicated situation. We have recently experienced a sharp slowdown of growth in the global economy. It started in the US last year, and has spread rapidly to Europe. At the same time, market disturbances in emerging market countries such as Turkey and Argentina created some uneasiness in the financial markets. The economic implications of the recent spectacular terrorist attacks in the US are yet to be seen.

In this uncertain environment, monetary and financial stability are of particular value. In the integrated world, these things are actually a matter of international concern. International organisations such as the International Monetary Fund have been working for some time already to create multilateral frameworks where common standards can be developed for monetary and financial systems, and where these systems can be benchmarked against each other. This international co-operation is focusing very much on the same principles of good governance, credible institutions, and transparent policy which have also been applied in designing the EMU.

The emergence of the global financial market place is actually a great possibility for the entire world economy, but it is also a great challenge to the monetary and financial systems of the world. It is in the nature of competition that it rewards those who are efficient, competent and credible, but creates difficulties for those who are not. It is the responsibility of monetary policy makers to ensure by their own transparency and consistency that global integration leads into an increasingly unified world and not to an unstable one.