Hermann Remsperger: Monetary policy - how relevant are other policymakers?

Welcoming address by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, to the 5th Bundesbank Spring Conference "Monetary policy: how relevant are other policymakers?", Eltville, 2 May 2003.

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Ladies and Gentlemen,

I have the pleasure to welcome you to this year's Bundesbank spring conference on issues concerning the relationship and interactions between monetary policy and other policies.

Regrettably, I have to tell you that the policy lecture to our conference had to be cancelled because Ken Rogoff informed us only very recently that he was not able to come.

The broad spectrum of subjects to be discussed today ranges from theoretical considerations about optimal fiscal and monetary policy co-ordination, the role of monetary and fiscal stabilisation policies up to empirical evidence on the interaction between monetary and fiscal policies.

In tomorrow's sessions we are scheduled to extend our perspective by explicitly taking into account the openness of the economy and look into the implication for exchange rates and exchange rate regimes in particular.

With the following remarks I only want to emphasize that the subject of our conference is highly topical from the economic policy point of view. However, a part of the subject has been with us for a rather long time.

At any rate it reminds me of my thesis in the 70s. At that time I came to the conclusion that a strictly rule-based monetary policy requires discretionary leeway for fiscal policy.

Meanwhile many central bankers - and I include myself - plead for the application of rules in fiscal policy. Such rules were created by the implementation of the Stability and Growth Pact in the European Union. I do hope that there will be sufficient time at our conference to discuss the importance of fiscal rules for monetary policy.

I have to admit, Ladies and Gentlemen, that when we were planning this conference we did not know how much the discussion about the ECB's monetary strategy would intensify. Now we are right in the middle of this discussion, which in my view reflects the first out of three political factors that form the background of our conference.

Why? Well, if you want to talk about the relationship between monetary policy and other policy areas not only in an abstract but in a realistic way, then you must have a clear idea of the applied monetary policy strategy.

1. Price stability

You will understand that I have no intention to forecast the outcome of this strategy discussion. Nevertheless there are two points on which we can be rather sure. First of all there is no doubt that the ECB will stick to its mandate of maintaining price stability. By doing this the ECB contributes towards economic growth. Monetary policy in the Euro area is not in itself an instrument to foster growth. Neither is it a means of fine-tuning the economy.

Due to these limitations of monetary policy other policies must be given a key role as far as economic growth and employment are concerned. I will come back to that later again.

Secondly, I want to emphasize that price stability is at present interpreted symmetrically almost without exception. Neither inflationary nor deflationary tendencies are in line with price stability.

I am convinced that this interpretation is not only important for the isolated perception of monetary policy. It also touches the relationship between monetary policy and other policy areas. Therefore, I would like to have a closer look at the definition of price stability.

The symmetric interpretation calls for a quantification of price stability with a rate of inflation above zero, for example a target range between +1% and +2%. Alternatively, we can also think of not quantifying the lower bound explicitly.

One reason for setting the rate of inflation which is in line with price stability somewhat higher than zero is the exaggeration of the "true" inflation rate by the measured change in the price index. I believe that the measurement bias in the euro area is not large but positive.

Irrespective of that, the risk of deflation - a situation which is difficult to control - requires a certain safety margin of the "true" inflation rate from the zero line. Such a need for a safety margin results, not least, from the fact that nominal interest rates cannot fall below zero. In my view, the interest rate cut by the ECB in April 1999 already made it very clear that, in order to prevent deflationary risks, the ECB is not targeting a zero inflation rate.

And I would like to add that the ECB has quite deliberately not centred the definition of price stability around zero. Instead, the ECB's definition of price stability was intended also to take due account of the problems that may arise from the measurement bias, from nominal wage rigidities and from the zero bound of nominal interest rates.

But even if the probability of touching the zero bound of nominal interest rates is small for the euro area as whole, we must bear in mind that deflation would have serious implications for the real economy, the financial system and the economic policy. I take the view that risks of this kind can be reduced by preventing a sustained fall of the inflation rate for the euro area as a whole below a safety margin of around 1%.

As regards the upper limit of price stability, I would first of all like to recall that the Governing Council of the ECB defined price stability as a medium-term increase in inflation for the euro area of below 2%.

As the monetary policy of the ECB is geared towards consumer prices for the euro area as a whole, a persistent overshooting of the price norm in some of the participating countries requires correspondingly lower rates of inflation in the other member states.

Some experts therefore perceive a risk that an "excessively ambitious" price norm might push some countries close to deflation. In their view, the enlargement of monetary union will tend to make this problem even more acute.

In my view, however, defining price stability by an inflation rate above 2% - as is often suggested on account of a lack of convergence within the euro area - would be hardly justifiable. The solution to this structural problem has to be found in appropriate measures of adjustment by the countries with higher inflation, with the aim of reducing existing differentials.

That is, at any rate, the objective to which all the participants in monetary union have committed themselves. There is no reason to water down that commitment at the expense of the stability objective.

2. Economic reforms

In my discussion of the ECB's primary objective I have emphasized that monetary policy in the euro area has a narrow mandate, which leads us to the second topical background factor of our conference, and by this I mean the urgency for economic policy reforms in Germany. Two are points should be considered.

First, there is no doubt that the efficiency of monetary policy is also dependent on other policy areas. In particular I am thinking of fiscal policy, but also of labour market policy.

And secondly, it seems obvious that the pressure on monetary policy could become very severe, if other policy areas do not sufficiently support growth and employment.

This, Ladies and Gentlemen, is one of the reasons, why we at the Bundesbank keep calling for reforms in economic policy.

Seen in that light, it should not have come as a surprise that the current state of the economy and of economic policy in Germany prompted us to take the floor in the ongoing debate on how to find "ways out of the crisis". That was precisely the title we gave to a paper we drafted in our Economics Department and which we sent to the government and to parliament in February and which we published shortly afterwards.

Our paper does not (and cannot) claim to offer a comprehensive solution for all of Germany's woes. But it does intend to go a step beyond the somewhat abstract calls for reforms and give those demands more substance.

An important aspect within a comprehensive approach to overcome Germany's problems is the balance between macroeconomic and structural policy measures. In this respect, our message is straightforward. We believe that traditional macroeconomic policies can play only a minor part in solving the problems that lie ahead.

Therefore, we set out concrete measures, such as cutting subsidies, limiting personnel expenditure, along with intensified privatisation and an outsourcing of public tasks to the private sector.

Another area requiring reform is tax policy. Tax policy must offer a clear and reliable perspective in the aftermath of the numerous measures and proposals which - in some cases - have produced contradictory effects and which have created uncertainty in the past few years.

The last two steps of the tax reform, which was passed by parliament in 2000, should be implemented in 2004 and 2005 as scheduled. If this jeopardises the consolidation course, provision should be made for further cuts in spending and tax benefits.

From a macroeconomic point of view, further cuts in income tax rates would be desirable. However, this cannot be envisaged until budget consolidation has been achieved or until there is willingness to finance lower tax rates by a further spending restraint or a broadening of the tax base. We at the Bundesbank proposed specific measures in this respect, such as the abolition of all reduced rates of turnover tax.

In the social security system far-reaching reforms need to be implemented in order to reduce non-wage labour costs. Social insurance contributions, which are a key element of such costs, are not only very high by international standards, but are rising substantially both currently and over the long term.

Besides further steps to liberalise the product markets, to abolish market barriers for new enterprises and to make the education system more effective, the most important area concerns the labour market.

Shortly after our proposals were published, the German chancellor gave a speech to parliament entitled "Agenda 2010" announcing comprehensive reforms. Of course, I would not dare to claim that we initiated the agenda, but some of its key principles are consistent with our paper.

The reform package contains a number of important measures along these lines. This is particularly true with regard to labour market policies. Unemployment assistance will be curtailed, the period for claiming unemployment benefits will be shortened, incentives to work in the low-wage sectors will be established and dismissal protection rules will be eased.

We hope that the ongoing reform debate brings about far-reaching results that will strengthen growth and employment. I am convinced that many of our reform proposals would also be helpful in achieving budgetary consolidation.

3. Fiscal consolidation

The debate on fiscal consolidation and the Stability and Growth Pact can be viewed as the third part of the current backdrop to our conference.

As you know, the deficit ratio in Germany clearly exceeded the 3% limit last year and is expected to do so again in the current year. Under these circumstances, it seems quite obvious that scope for discretionary loosening does not exist.

In fact, those member states of the EU with large deficits are currently in a fiscal trap; they have virtually no room for manoeuvre if they do not wish to violate the Maastricht Treaty and the Stability and Growth Pact.

This state of affairs cannot be blamed on the European treaties, which envisage sufficient fiscal flexibility as long as a balanced budget in underlying terms is achieved. Instead, the main reason for this situation is that these countries did not sufficiently consolidate their budgets while their economies were performing more favourably.

In our view, the relevant European authorities have found an acceptable compromise on this matter. Those countries with budgetary imbalances are to reduce their structural deficits by at least ½% of GDP each year, but otherwise allow the automatic stabilisers to take effect. For Germany, the Ecofin Council required a structural consolidation of about 1% this year.

The main conclusion for Germany is that there is virtually no scope for stimulating fiscal action. The government has envisaged a budget "close to balance" in 2006 in line with the Stability and Growth Pact. The overall structural deficit ratio stood at almost 3% in 2002.

Given that a deficit ratio of ½ % of GDP is tolerated and including shortfalls resulting from tax cuts in 2004 and 2005, the structural consolidation requirement stands at about 3½ % of GDP within four years. If this is to be achieved solely through the spending side (as it should), nominal spending of federal, regional and local government has to remain more or less unchanged between 2003 and 2006.

That is an extremely ambitious target - particularly taking into account that the underlying economic assumptions are very optimistic. Therefore, additional steps would appear to be necessary in order to safeguard the consolidation course.

4. Policy mix in Germany

Let me now emphasize that some of the issues we are discussing at our conference already have a long history. That is especially true of the relationship between monetary policy and fiscal policy. In Germany, there have been widely differing combinations of the monetary policy regime on the one hand and the fiscal policy regime on the other. Allow me to mention a few examples.

After two major inflations - both of which were driven by excessive public deficits and financed by the printing press of the central bank - the main aim of the "Bundesbank Act" in 1957 was to prevent a further repetition of inflation.

The German Parliament agreed on a clear separation between monetary and other economic policy areas, which should be safeguarded by the following three principles: first, a clear assignment of the policy goal of the Bundesbank as "safeguarding the currency", second, formal independence from Government interventions in monetary policy matters, and third a prohibition of financing the budget by means of the central bank.

However, the historical experience of German monetary and fiscal policy shows that some substantial problems remained. Above all there was a lack of rules which prevented excessive budget deficits. The "golden rule" of public borrowing was not a sufficient protection against the accumulation of debt. From the beginning of the 1960s, the welfare state was greatly expanded.

In 1966, inflation rose to almost 4% which was very high compared to previous years. The Bundesbank tightened monetary policy in order to dampen inflation, while public sector borrowing was rising further due to tax reductions and booming Government spending. The need for supportive fiscal stabilisation policy was by and large ignored by the Government.

The economic slowdown in 1966 triggered a budget crisis. The ruling coalition Government could not agree on a way to consolidate the budget. In 1967 Germany experienced its first recession.

At this time German budget rules did not allow for active stabilisation policy which contrasted with the increasing demand side-orientation of that period. According to those supporting Keynesian demand management, this was a shortcoming which made a reform of budget rules necessary.

A new article was included into the constitution which laid down that the Federal Government and the Governments of the Länder had to take the overall equilibrium of the economy into account when setting fiscal policy.

The so called "Stability and Growth Law" specified that fiscal policy should aim simultaneously at a stable price level, a high level of employment and the equilibrium of the balance of payments, while enabling a continuous and stable path of economic growth. It was this assignment of goals which led to stronger Government activity and an increase in public debt.

It took only a few years until the key problem with the attempt to fine-tune aggregate demand became obvious. It became apparent that fiscal policy programmes tend to lead to a rise in the ratio of public spending to GDP over time.

While at the beginning of the 1960s the public sector share in GDP had amounted to roughly 33%, it reached 42% in 1973. This rise was mainly financed by additional borrowing. The overheated economy reached record levels of inflation, which peaked after the impact of the first oil price shock to almost 7% in 1973.

Crucial for this development was the exchange rate commitment of the Bundesbank under the Bretton Woods system and its resulting inability to regain control over monetary and credit expansion.

After the Bretton Woods system the Bundesbank regained control over domestic monetary expansion. Its monetary policy framework was reviewed and adjusted. Eventually this led to a clear assignment of policy goals and instruments.

From a pure monetary perspective the result was encouraging. The Bundesbank got inflation under control. Initially, however, fiscal policy took expansionary measures in the aftermath of the oil price shock.

At that time it was not generally acknowledged that a high value of public debt could create fears of future tax increases. And such fears could reduce current private spending, thus rendering public deficit spending ineffective. A shift towards a more sustainable supply-side-oriented path of public finances became necessary. This was realized in the early 1980s.

The paradigm change in fiscal policy was quite successful: Until the end of the 1980s public spending was cut back to a level of 46% of GDP, a major tax reform was implemented and the public sector deficit was nearly cut back to balance.

Before being able to reap the full benefits from these efforts, our economy was confronted with the challenge of the German reunification. Mostly due to the huge amounts transferred to the new Länder, the public debt ratio rose by 15 percentage points between 1989 and 1995. The tax burden (including social security contributions) increased considerably.

In spite of the budget problems and the expansionary monetary shock resulting from the conversion of East German financial assets and liabilities into D-Mark, monetary policy successfully defended the purchasing power of the currency.

In summarizing, I would like to stress that German monetary policy has been successful in fighting inflation because politicians were wise enough to make the Bundesbank independent. At the same time the German experience (along with the experience in many other countries) shows that the lack of fiscal rules may lead to ever increasing public debt.

Hence, the institutional set-up for EMU, which comprises not only an independent ECB and independent national central banks but also the Stability and Growth Pact, can be seen not only as an adoption but also as an improvement of the German practice before the introduction of the single currency.

This approach should lead to a more sustainable path of public finances and will hopefully limit conflicts between fiscal and monetary policy. With this hope I would like to conclude my opening remarks.