Mr. Issing comments on the problem of credibility of the European Central Bank Contribution of Prof. Otmar Issing, a member of the Directorate of the Deutsche Bundesbank, at the Annual Meeting of the American Economic Association, held in Chicago on 4/1/98.

On January 1, 1999 the curtain will rise on a worldwide première. It will be the first time ever in history that sovereign states have abandoned their own currencies in favour of a common currency and transferred their monetary policy sovereignty to a newly created supranational institution. What makes this process all the more unusual from an historical perspective is that the national currencies involved are not being abolished because of their weakness; on the contrary, proof of a large measure of monetary stability is demanded as a precondition for what is essentially a political project.

The euro will likewise have to demonstrate a large measure of stability if it is to contribute successfully towards integrating Europe and not towards dividing it. Various individuals have vowed emphatically in the past that this will indeed be the case. However, public statements in favour of a stable euro hardly constitute a copper-bottomed guarantee on their own.

Why should rational citizens be expected to believe these promises? It is a question of the credibility of announcements and of economic institutions. The catchword "credibility" points to a mountain of publications which, following the pioneering work of Kydland and Prescott (1977) and of Barro and Gordon (1983), have appeared since then.

The European Central Bank (ECB) will represent the birth of a completely new institution. The euro will replace national currencies which - like the D-Mark - can look back on a successful past history. On the other hand, the potential participating countries are insisting on retaining their political sovereignty. For the foreseeable future, therefore, monetary union will lack the reinforcement of a political union.

Understandably, this state of affairs has fired the imagination of economists. The publications on this subject now fill whole libraries. Even if, ultimately, the complex phenomenon of European monetary union (EMU) cannot be clinically dissected, I would like to emphasise one point: the credibility of the ECB.

In the Maastricht Treaty the signatory states opted for a very specific central bank constitution. Does their choice stand up to the critical assessment of professional economists? What criteria for the establishment of a central bank can be derived from theory and empirics? Is there a normative theory of central bank constitutions at all? First of all, however, we should consider why credibility is important and how it can be established.

I The problem of credibility

As a general principle, credibility facilitates interpersonal relationships. Credibility is capable of substantially reducing transaction burdens. In terms of monetary policy, this always boils down in the end to the promise of stable money. At first sight, therefore, the problem appears to be reduced to the call for absolute stability in the value of money.

Hence, in the sense of a constant unit of account, Irving Fisher's index currency would be the appropriate answer. But this view did not prevail among the theoreticians. Back in

1935 Hayek already pointed to the conflicts between price level stabilisation and shifts in relative prices.

Price level stabilisation is generally no longer prescribed as an objective today. Even in the discussion on zero inflation there is no demand to reverse an increase in prices caused, say, by terms-of-trade effects. Moreover, problems of inflation measurement are currently featuring strongly again.

This gives rise to two tasks in tackling the problem of credibility in monetary policy practice. Firstly, monetary policy makers must define the (positive) rate of inflation which they target over the medium term, which the general public has to expect and by which they can judge the central bank's performance. Secondly, the central bank has the task of explaining any deviations from this rate to the general public and to make it clear how and within what time-frame it intends to bring inflation back on to the target path. Quite clearly, these factors are especially important above all in the context of inflation targeting (M. King, 1997).

In monetary policy practice and theory alike this problem is closely linked to the question of the relevant aims of central bank policy.

For the sake of brevity, let me postulate the following three principles as the quintessential findings of a multitude of publications:

- There is no long-term trade-off between inflation and unemployment or growth.

- The transient costs of macroeconomic stabilisation policy depend not only on the central bank's credibility but also - and above all - on the degree of microeconomic flexibility.

- Central bank independence significantly enhances the probability of monetary stability. It entails no output losses.

II Building up credibility

Experience shows that those central banks which have a successful record of stability behind them are most likely to enjoy credibility. Very broadly, such a successful track record is characterised over the long term by a low level of, and a small variation in, the inflation rate.

When prices rise, the crucial factor is the underlying cause. A fundamental consideration in building up and defending an anti-inflationary track record is that the central bank should never resort to the instrument of unanticipated inflation. If the public feels duped by the central bank, that central bank forfeits it credibility for many years to come.

If, on the other hand, prices rise for exogenous reasons, the subsequent disinflationary policy course can actually enhance the central bank's reputation. The phase following German reunification is a case in point. In the context of the reunification boom and a sharp increase in unit labour costs, the annual rate of price increases in the years 1991/92 came dangerously close to 5% (in western Germany). Once the general public was convinced that the Bundesbank would not tolerate any acceleration in the rate of inflation, long-term interest rates responded positively even before the inflation rate declined.

Considered from this aspect, the whole discussion about rules versus discretion revolves around the problem of how far monetary policy makers need to be bound to a formal rule in order to convince the public *ex ante* of the central bank's unwavering commitment to its set task. For monetarists the answer is clear. In addition, a strict monetary rule also protects the central bank against political pressure. But such a rule also prevents the central bank from making mistakes which inevitably result from the attempt to seek constantly to examine all available information for its relevance and to make it usable for discretionary decisions.

Other approaches to overcoming the problem of dynamic inconsistency or insufficient credibility are targeted at the policy makers themselves. According to Rogoff (1985), for example, monetary policy should be entrusted to conservative central bankers. Contractual solutions à la Walsh (1995), with a clear-cut target and strict penalties in the event of its non-achievement, likewise belong in this category.

Hardly anyone would deny that credibility is extremely important. Any monetary policy that lacks credibility must be paid for with higher real interest rates. The expectations of a well-informed and fundamentally critical general public must not be disappointed. Central banks have to take this into account in pursuing their policy; above all, they should take care not to exacerbate any prevailing uncertainty through their own policy. There is little to suggest that the necessary policy-based stabilisation of expectations can be achieved by means of a purely discretionary approach.

III The European Central Bank

Obviously, the new ECB will have no established track record to inspire confidence. To what extent the accumulated credibility of national central banks which will form part of the European System of Central Banks from the beginning of stage 3 can be transferred to the new institution is an open question. One must therefore resort to theoretical insights and empirical lessons in seeking to predict the level of credibility that will be enjoyed by the ECB. The main criteria for making this prediction are the ECB's Statute, strategy and leading personalities.

The Statute

The Maastricht Treaty gives the European System of Central Banks (ESCB) a clear mandate in Article 105: "The primary objective of the ESCB shall be to maintain price stability." Its support for the general economic policies in the Community must be without prejudice to the objective of price stability. Article 107 guarantees the decision-making bodies independence in making their decisions. The members of the Executive Board are to be appointed for eight years, and that term of office shall not be renewable (Article 109a). By contrast, the Governors of the national central banks, who are to be appointed for at least five years, may be reappointed (Article 14, Protocol on the Statute of the ESCB and the ECB). The EMI has already proposed that longer terms of office should be chosen.

I think it goes without saying that an independent central bank cannot freely choose its own objectives. But the mandate of price stability has to be defined more precisely; an initial consensus has already been achieved. "While theory does not provide a precise definition of price stability and while measurement problems exist, there has been a broad consensus among central banks for several years that a range of 0%-2% inflation per annum would be appropriate" (EMI).

To this extent, therefore, the theoretical insights and empirical lessons are adequately reflected in the Statute. Does that mean that the credibility problem has automatically been solved? Many politicians - but also quite a few economists - think so. In Germany, for instance, commentators incessantly point out that the ECB Statute, especially as regards its constitutional status, is even more rigorous than the Bundesbank Act. They conclude that the euro will be as stable - a frequently heard formulation is "at least as stable" - as the Deutsche Mark.

Nevertheless, hardly anyone will expect that the ECB will want or be able to keep the inflation rate below 2% perpetually and under all circumstances. Additional efforts will therefore be needed to establish credibility convincingly from the outset. This is all the more necessary as, given the high unemployment in most European countries, pressure will be exerted on the ECB right from the start to tone down the priority of price stability in favour of boosting employment. That is the tenor of demands now being made to amend the Statute accordingly.

Incidentally, the provision according the powers to make exchange rate arrangements is likewise a potential source of vulnerability. Pursuant to Article 109, the EC Council may, subject to certain preconditions, conclude formal agreements on an exchange rate system in relation to non-Community currencies. Subject to similar conditions, the Council may formulate general orientations for exchange rate policy in relation to non-Community currencies.

Strategy

In respect of monetary policy instruments, the Treaty contains only general guidelines and otherwise gives the ECB complete freedom in implementing its policy. For the ECB, as a new institution, it is imperative that it undertakes a precommitment in relation to the general public to which its policy is bound and which makes it accountable. The preparatory work undertaken by the EMI has reduced the possible alternatives to just two strategies, that is monetary targeting and inflation targeting.

A monetary target emphasises the central bank's responsibility for monetary conditions and demarcates its responsibility vis-à-vis other policy areas and exogenous shocks. Monetary targeting informs the public about the central bank's fundamental orientation and can thus help to stabilise inflation expectations. In adopting such a precommitment, the ECB would subject itself to a sharp discipline; it will have to justify any deviations from the target path to the public.

The empirical studies undertaken so far indicate that the money demand in the euro area should be sufficiently stable for a strategy of monetary targeting (and more stable than in the individual countries). There is thus a good chance that, from a "technical point of view", monetary targeting will fulfil the prerequisites.

On the other hand, we should remember that the initial phase of monetary union, in particular, will be burdened by a number of imponderables. Clearly, these could have an impact on the growth of the money stock. It is thus advisable to supplement the strategy of monetary targeting pragmatically (but not arbitrarily) by including some elements of direct inflation targeting. The multitude of additional information could be compressed in this sense into a formal inflation forecast.

Personalities

The ECB Statute does not seek to establish a currency standard excluding all and any room for discretionary manoeuvre. Consequently, a role will be played by the personalities responsible for formulating and implementing monetary policy. That applies especially to an institution which is completely new.

Public controversies about the filling of top posts damage credibility. Monetary union will not be additionally bolstered by a political union. The leading personalities will therefore be associated almost inevitably with their respective national states, yet in the end they are to execute a common policy, namely a single European monetary policy, and to withstand political pressure. The same applies, by the way, to the Governors of the national central banks. Misgivings are therefore called for if, for example, there are intentions to introduce accountability towards the national parliament.

IV Conclusion

The Maastricht Treaty has largely laid the foundations for a stability-oriented monetary policy as far as the institutional arrangements are concerned. Those foundations need to be complemented by an appropriate strategy and a convincing decision regarding the choice of the leading personalities.

The launching of a new central bank and a new currency is accompanied by uncertainty. The associated risk premium in the interest rate can be kept down by choosing an appropriate strategy and suitable top executives. The financial markets will keep a critical eye on the ECB right from the start. The initial monetary policy course thus takes on crucial importance. Some people are therefore already advising the ECB to pursue a particularly restrictive course right from the outset so as to nip any mistrust in the bud, as it were.

Such an uncompromising approach would inevitably give rise to tensions within the Council. It is also hard to imagine that the ECB would meet with general approval for such a course among the people of Europe, given the high level of unemployment. At the moment we do not even know whether there is a stable European consensus on the acceptable or optimal rate of inflation. The trend towards the convergence of inflation rates at a low level is a good omen. In a monetary union without a flanking political union, we shall simply have to wait and see whether this convergence of preferences will prove to be a lasting phenomenon.

The consensus regarding the preference for stable money - the common "stability culture" - is all the more important as monetary union will have to survive for the foreseeable future without the additional support of a political union. For this reason, the right choice of participants based on the convergence criteria takes on supreme importance. The public finance position plays a particular role in this assessment. The fiscal criteria have to be met on a sustainable basis, in other words not just at the beginning of stage 3. Finally, the member states must implement the crucially necessary reform of their labour markets and in general significantly cut back the dense jungle of overregulation. Without a far greater degree of flexibility at the microeconomic level it will neither be possible for monetary union to yield the desired benefits nor for the ECB to find broad and ongoing acceptance for a monetary policy geared to ensuring price stability in accordance with the Maastricht Treaty.