Otmar Issing: The ECB and the euro - the first five years

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1. A new central bank and a new currency

When the European Central Bank started to think about how to conduct monetary policy for what has since become the euro area, it faced extraordinary challenges. A single monetary policy for a currency area comprising 11 - and now 12 - countries with sovereign national governments - how was this going to work? To start with, there was a general consensus among academics that the euro area was ex ante not an optimum currency area.[1] And this was not the only complicating factor: there were national differences in the transmission of monetary policy; there was the risk that countries could be hit by asymmetric shocks; there was the issue of whether autonomous national fiscal policies could be considered compatible with a supranational monetary policy; and, moreover, there was the question of whether, on account of the decentralised nature of the Eurosystem, national interests would dominate the implementation of monetary policy. Critical observers took the view that a single, stability-oriented monetary policy was doomed to failure.

The factors contributing to economic divergence in the euro area need not necessarily be regarded as a given. In particular, one might expect that closer financial market integration would also entail convergence in the transmission of monetary policy impulses.

Furthermore, we should not overlook the fact that all countries adopting the euro successfully undertook considerable efforts to implement sustained, stability-oriented policies. The criteria agreed upon at the EU Council meeting in Maastricht in 1991 (relating to price stability, public finances, exchange rate stability, long-term interest rates and central bank independence) served as both a target and a disciplining device for economic policies in EU Member States throughout the 1990s.

However, there were also more practical concerns regarding the actual conduct of monetary policy. Particularly at the outset, the Governing Council had only a very limited set of reliable harmonised macroeconomic data at its disposal which it could rely on in order to assess the economic situation. Some important data were not even available for the euro area.

Today, the euro has not merely survived: it is firmly established as a stable currency. Against the background of all the concerns expressed and in the light of the experience gained over the first five years of monetary policy, it is time to take stock. This lecture will look at the key elements of the ECB's monetary policy strategy, namely the framework for internal analysis and decision-making, which encompasses the ECB's economic and monetary analysis. With particular regard to the role of money and the ECB's medium-term orientation, I will consider the extent to which this approach differs from inflation targeting strategies. I will also discuss the considerations underlying our quantitative definition of price stability, such as the trade-off between the costs related to inflation and reasons for tolerating small positive rates of inflation. I will also dwell briefly on our approach to communicating with the markets and the wider public. The ECB has been granted full independence from political interference in the pursuit of its overriding objective: the maintenance of price stability. However, it is still accountable to the European public in that respect. This requires transparency in all areas relevant to the fulfilment of its mandate and a willingness on our part to convey to the public, in a consistent and systematic way, all information relevant to our decision-making.

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1 See Bayoumi and Eichengreen, 1993a and 1993b.

2. Mandate and strategy of the ECB

2.1 Main elements of the strategy

The degree of uncertainty with which the ECB was confronted at the outset made it necessary, first and foremost, to avoid major errors. Not least because of the ECB's lack of a track record, it was simply inconceivable for the single monetary policy to be pursued on a purely discretionary, ad hoc basis. A systematic framework for decision-making, communication and the assessment of the economic situation and future risks to price stability was therefore needed.

In October 1998 - that is to say well before the responsibility for monetary policy passed from the national central banks to the ECB - the Governing Council decided on a stability-oriented strategy that would meet these requirements.[2] The strategy was based on fundamental theoretical considerations and empirical knowledge, as well as on decades of policy experience acquired by the national central banks.[3] When the ECB's strategy was evaluated - and reaffirmed - in 2003, it was necessary to review those considerations in the light of the experience gained over the first four and a half years of monetary policy.

As I have already mentioned, the Treaty establishing the European Community makes price stability the primary objective of the ECB. However, the Treaty gives no indication of how exactly that is to be understood. In October 1998 the ECB chose to specify its mandate by announcing a quantitative definition of price stability. It thereby sought to establish a solid anchor for inflation expectations and set a benchmark which the public could use to hold the ECB accountable. Price stability was defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% to be maintained in the medium term. This recognises that monetary policy cannot control price developments in the short term and should not therefore seek to do so. The use of the term "increase" made it clear from the outset that extended periods of deflation are no more compatible with price stability than deflation. The 2% upper bound for price increases was set some way above zero, providing a safety margin to guard against deflation. There were uncertainties concerning the possible extent of any measurement bias in the HICP. As a result, the ECB did not define a specific lower bound for the rate of price increases.

2.2 Considerations regarding the definition of price stability

A number of features were relevant to the choice of the price index. The index was to be comprehensible for the public and not subject to excessively frequent revision. Furthermore, it was to be available with sufficient timeliness and frequency, if possible on a monthly basis. The ECB, seeking a price index that met those criteria, chose to define price stability in terms of the HICP, as calculated by Eurostat.

When establishing a quantitative definition of price stability, it was necessary to balance the costs of inflation against possible reasons for tolerating low positive rates of inflation. The welfare-reducing effects of inflation, identified by a large body of research, are well known, even if they are difficult to measure: the disruption of the allocation of resources through the distortion of relative prices; the effect of the level of inflation on uncertainty surrounding inflation and associated risk premia in long-term interest rates; the exacerbation of the distortionary effects of taxation; the artificial expansion of the financial sector; and other wasting of resources.[4] Looking at recent research on the basis of general equilibrium models, one could even conclude that central banks should aim at zero inflation.[5]

However, there are several factors in favour of basing the monetary policy objective on a positive, but low, rate of inflation. One fundamental reason relates to the zero lower bound on nominal interest rates. The nearer the target inflation rate is to zero, the greater the risk that central banks might be unable to react sufficiently to deflationary shocks by reducing interest rates. If the shock were severe

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[2] See ECB, 1998.

[3] See Issing, Gaspar, Angeloni and Tristani, 2001.

[4] See in relation to the costs of inflation Feldstein, 1997 and 1999; Fischer, 1981, the collection of papers presented at the ECB conference Why Price Stability?, ECB, 2001, and the overview in Rodríguez-Palenzuela, Camba-Mendez and García, 2003.

[5] See Rodríguez-Palenzuela, Camba-Mendez and García, 2003.

enough, the economy could even be pushed into a deflationary spiral, in which price falls accelerate. Although monetary policy in such a situation still disposes of other instruments, the reduction of nominal interest rates will have reached its limits at the zero bound. The real interest rate would therefore increase with deflation. If, on the other hand, the central bank's target in the medium term is not zero inflation, but rather a low, positive rate of price increases, the nominal interest rate will, with a given real equilibrium interest rate, also rise. That provides greater scope for reacting to negative demand shocks by means of interest rate reductions. Numerous studies indicate that this can be assumed to be the case if central banks aim to maintain the inflation rate above 1%.[6]

A further factor in favour of tolerating low, positive levels of inflation is the possible existence of a positive measurement bias in the calculation of the consumer price index. This can arise as a result, in particular, of inadequate compensation for improvements in the quality of goods in the underlying basket. Research suggests that, with regard to the HICP used by the ECB, the size of the measurement bias is minimal. And, in view of the improvements being made to Eurostat's calculations, this can be expected to decline even further.[7]

A further argument relates back to the idea that a positive rate of inflation may support the necessary adjustment of relative prices to economic shocks where wages and prices are subject to downward nominal rigidities. However, the degree of such rigidities may very well depend on the extent to which a stability-oriented monetary policy regime is successful in gaining credibility. Such rigidities cannot be regarded as an invariable structural feature of an economy. So, a central bank certainly does not want to be seen to be accommodating nominal rigidities by consciously aiming at a higher rate of inflation.[8]

Inflation differentials brought about by the Balassa-Samuelson effect[9] are often cited as another reason for seeking to achieve a positive rate of inflation. Otherwise, the possible existence of downward rigidities in prices and wages in the euro area could give rise to excessive costs in countries and regions with lower than average inflation over the longer term[10] and, in extreme cases, deflationary trends could even take hold at a local level. Inflation differentials within a currency area are a perfectly normal phenomenon, and so the Balassa-Samuelson effect does not seem to be a particularly important consideration either. A number of empirical studies suggest that the average rate of inflation in countries with a lower rate of price increases will be at most half a percentage point lower than the euro area average. The potential enlargement of the euro area does not fundamentally alter this picture.

In May 2003 the Governing Council conducted a careful reassessment of these principal considerations underlying the definition of price stability. In confirming the quantitative definition of price stability, the Governing Council made it clear that, over the medium term, its monetary policy would seek to achieve an inflation rate "below, but close to, 2%".[11] This takes sufficient account of all the factors in favour of aiming at a low, positive rate of inflation.

2.3 The two pillars of the strategy

In view of the uncertainties mentioned at the beginning of this lecture, the strategy had to provide a sound and systematic framework for internal analysis and decision-making. This framework was also needed as a basis on which to communicate our decisions to the public.

A price stability-oriented policy must always take account of the nature and size of economic shocks, from which risks to price stability can emerge, and of the way in which these shocks affect the expectations of economic agents. This requires the comprehensive and systematic use of all relevant information, based on a diverse set of indicators and models. In this vein, the Governing Council's strategy review confirmed that its assessment of the risks to price stability encompasses two

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6 See Coenen, 2003b; Klaeffling and Lopez-Perez, 2003; and Orphanides and Wieland, 1998.

7 See Camba-Mendez, 2003, and Wynne and Rodríguez-Palenzuela, 2002.

8 See Coenen, 2003a and 2003b, Card and Hyslop, 1997, Akerlof, Dickens and Perry (1996).

9 See Balassa, 1964, and Samuelson, 1964.

10 See Rodríguez-Palenzuela, Camba-Mendez and García, 2003.

11 See ECB, 2003a and 2003b.

complementary perspectives: an economic and a monetary analysis. These have become known as the two pillars of the ECB's strategy.

The economic analysis focuses mainly on the assessment of current economic and financial developments from the perspective of the interplay between supply and demand in the goods, services and factor markets. In this respect, the macroeconomic projections serve to structure and synthesise a large amount of economic data. Nevertheless, these cannot be regarded as an all-encompassing tool for the conduct of monetary policy. I will elaborate on this issue in a moment.

The monetary analysis serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications arising from the economic analysis. In October 1998 the Governing Council assigned a prominent role to money in recognition of the fact that, in the medium to long run, monetary growth and inflation are closely related. This provides the Governing Council with key information at time horizons stretching beyond those usually adopted for the construction of central bank inflation projections. The prominent role assigned to money in the ECB's strategy is signalled by the announcement of a reference value for monetary growth. However, the monetary analysis seeks to provide a comprehensive survey of the liquidity situation, thereby going far beyond an assessment of monetary growth in relation to the reference value.

In 1998 the ECB also discussed a strategy of direct inflation targeting as a particularly relevant option. In its strategy review the Governing Council again looked closely at the arguments.

In the last two decades many countries have moved to a stability-oriented monetary policy framework. As a result, central banks have made a credible commitment to targeting low and stable inflation rates. In this context, a number of central banks have chosen a strategy of inflation targeting. Essentially, this encompasses the following: (1) price stability as the primary objective; (2) the public announcement of an inflation rate to be maintained over a more or less precisely defined time horizon; (3) transparency of the monetary policy strategy through appropriate communication with the markets and the public on monetary policy decisions; and (4) greater accountability on the part of the central bank as regards the fulfilment of its mandate. In retrospect, the policies pursued within this framework have been a great success in terms of achieving price stability. Particularly in countries which, starting from a relatively high level of inflation rates, announced a disinflation process, inflation targets were a suitable means of bringing inflation expectations into line with the monetary authorities' objective.

These features of inflation targeting characterise nearly all stability-oriented central banks. In this general sense, Ben Bernanke has even described the Deutsche Bundesbank as a "prototype inflation targeter".[12] Much the same could be said of the ECB. Normally, however, inflation targeting is also defined as a strategy in which macroeconomic forecasts - in particular for the inflation rate - serve as an intermediate target, i.e. as the primary or even all-encompassing variable for monetary policy decision-making and external communication.[13] In this respect, inflation targeting has been understood as inflation forecast targeting.

The ECB quite consciously dismissed this strategy, and - I believe - with good reason.[14] The use of inflation forecasts as an intermediate target has mostly taken the form of a procedure whereby a central bank selects, from among a range of simulated alternatives, the interest rate path for which expected inflation at a certain point in the future coincides with the inflation target.[15] Such focus on a fixed horizon does not seem robust; nor would it appear optimal from a welfare perspective. The horizon over which to pursue price stability is to a substantial degree contingent on the size and nature of shocks affecting the economy, as well as on the initial state of the economy. For example, to maintain the same degree of volatility of inflation and output, monetary policy can compensate for demand shocks over shorter periods than price shocks, which move inflation and output in opposite directions. Furthermore, this approach ignores the implications which an interest rate path simulated in this way may have for price stability at longer horizons. In particular, it ignores the fact that - for a given interest rate path - the longer the horizon, the further the inflation rate can deviate from the target.

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12 See Bernanke, 2003.

13 See Svensson, 1997; 1999, p. 623.

14 See Issing, 2003.

15 See Svensson, 1999; Bowen, 1995, p. 57.

In addition, the construction and publication of central bank forecasts can raise a whole number of problems which severely limit the relevance of such forecasts for monetary policy. One of the main problems lies in constructing a forecast which is consistent with the underlying interest rate path. Exogenous assumptions with regard to the interest rate path - such as assuming constant interest rates - typically lead to instabilities or indeterminacy.[16] At the same time, bringing exogenous assumptions on the interest rate policy into line with the expectations of economic agents underlying these forecasts in a credible and convincing way constitutes a considerable challenge in practice. The aforementioned simulation of alternative interest rate paths is thus barely practicable. An alternative to this would be to use market interest rates, as opposed to a fixed interest rate. If the central bank's reaction function is understood by the public and the markets and if its monetary policy enjoys credibility, the interest rate path expected by the market will mostly be consistent with the envisaged inflation target. However, if new economic shocks arise, it can be extremely difficult to communicate necessary deviations of the monetary policy stance from the interest rate path anticipated in this way. This can place an undue restriction on the ability of monetary policy to react in a timely manner to changes in economic conditions and in risks to price stability.

Last but not least, inflation forecast targeting neglects the information stemming from monetary developments. Up to now it has not proved possible to integrate the monetary side into the inflation forecast in a satisfactory manner. Whether this will ever be possible in a convincing way - not least on account of the different horizons involved - remains a matter of conjecture. At any rate, the Governing Council is adhering to its stance of considering all important indicators and of according monetary factors a prominent position in its assessment of the risks to price developments and thus in its monetary policy.

2.4 The medium-term orientation of the ECB's strategy and the role of money

For good reason the ECB has chosen a strategy which does not focus exclusively on either a single indicator or a single analytical tool - be it money or an inflation forecast. By contrast, the strategy offers an appropriate means of bringing together different analytical perspectives and of using all the information relevant to decision-making in a systematic way. The advantages of this approach are increasingly being recognised, not least from the perspective of the relationship between monetary and credit developments and asset prices.

The appropriateness of inflation targeting strategies has come under particular scrutiny in the context of the share price booms witnessed in the 1990s, their subsequent collapse and the effects that this had on the financial system.[17] If financial imbalances accumulate and there is, for example, a sharp, broadly based increase in asset prices, there is little sense in continuing to pursue an inflation forecast for consumer prices over a horizon of one to two years. In such circumstances it may instead be advisable to set interest rates with a view to a time frame extending well beyond conventional forecast horizons - e.g. in the face of substantial uncertainty about the sustainability of asset price movements.[18] With its medium-term orientation, the ECB pays due attention to the need to take into account the entire horizon over which monetary policy impacts on the state of the economy.[19]

Here the pre-emptive role of the monetary analysis has also been acknowledged.[20] Growth rates of money and credit which are persistently in excess of those needed to sustain economic growth at non-inflationary levels may, under certain circumstances, provide early information on emerging financial instability. Such information is of relevance for monetary policy because the emergence of asset price bubbles could have a destabilising effect on activity and, ultimately, prices in the medium and longer term.[21]

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[16] See Woodford, 2000.

[17] See Bean, 2003.

[18] See Kent and Lowe, 1997; Bordo and Jeanne, 2002.

[19] See Issing, 2003.

[20] See Borio, English and Filardo, 2003.

[21] See Borio and Lowe, 2002; Masuch, Nicoletti Altimari, Pill and Rostagno, 2003.

2.5 Transparency and accountability

The Maastricht Treaty clearly assigns to the Eurosystem responsibility for the maintenance of price stability. And it has granted the ECB full political independence in its pursuit of this goal. The independence of the ECB and the need for transparency and accountability go hand in hand. Given the European nature of its mandate to maintain price stability and its independent status, the ECB is accountable to the European public and its elected representatives. This requires transparency in all areas relevant to the fulfilment of its mandate and a willingness to convey to the public, in a systematic and consistent way, all information relevant to its decision-making. Transparency is also essential to the effectiveness and success of the ECB's monetary policy. It should contribute to the anchoring of inflation expectations and minimise false expectations on the part of financial markets and the wider public regarding policy responses. For these reasons, the monetary policy strategy has been a key device. It clearly specifies how the ECB's policy objective is to be understood. And it provides a clear and coherent framework for structuring information and the decision-making process internally and explaining the ECB's policy stance to the general public.

The full specification of a policy rule or complete transparency as regards the underlying information set is impracticable. Where communication with the public is concerned, it must therefore be acknowledged that a higher degree of disclosure does not necessarily mean greater transparency.[22] There is clearly a need to strike a balance between, on the one hand, being clear enough to be properly understood by the general public and, on the other, providing information which is sufficiently comprehensive to do justice to the uncertainties and complexity of the decision-making process. In fact, it has been a particular challenge to achieve clarity in our communication - i.e. to send clear, coherent and consistent messages to the markets and the wider public, thereby preventing misunderstanding and false expectations.

The regular publication of the Governing Council's assessment of the economic situation and the associated risks to price stability are an important part of our quest for transparency. Monetary policy decisions are regularly explained at the press conference which takes place immediately after the first Governing Council meeting of the month. Further details are presented in the ECB's Monthly Bulletin, in the speeches given by members of the Governing Council and in the President's testimonies before the European Parliament. With its monthly press conference, the ECB was the first central bank to provide such extensive and open real-time diagnosis - and other central banks are now moving in the same direction.

3. The conduct of monetary policy: the experience of the first five years

Since the introduction of the euro, how successful has the ECB's strategy been as a monetary policy framework for reacting to economic shocks in a way that ensures that price stability is maintained over the medium term?

One of the features which dominated the early years of European monetary policy was the existence of substantial and prolonged price shocks between the second half of 1999 and 2001. Initially the strongest impact came from a sharp increase in oil prices in conjunction with a general rise in import prices, reflecting exchange rate and global price developments. By the end of 2000 oil and import prices had risen to levels unseen since the beginning of the 1990s. While this trend reversed in 2001, the food price component of the HICP rose considerably on account of livestock diseases. These were the main reasons why year-on-year inflation rose to more than 3% in May 2001.

These factors were naturally beyond the ECB's control. In this context, and also on account of the robust economic growth witnessed in 1999 and 2000, the still booming stock markets and the continued accumulation of excess liquidity, the Governing Council progressively increased the interest rates on the main refinancing operations by 225 basis points between November 1999 and October 2000 with the aim of maintaining price stability in the medium term. In particular, the aim was to prevent the shocks in question from affecting medium to long-term euro area inflation expectations.

Despite the prolonged impact of sharply rising food prices, it emerged in 2001 that, on account of weakening demand and the gradual reversal of monetary trends, lower interest rates were required in order to maintain price stability over the medium term. Accordingly, the Governing Council decided to

[22] See Poole, 2004 and Issing, 1999.

lower interest rates from the spring of 2001 onwards. In so doing, the Governing Council reacted in a timely fashion to a number of negative demand shocks which later continued in the context of global uncertainties (such as those related to the terrorist attacks on 11 September 2001 and the wars in Afghanistan and Iraq). Since June 2003 the Governing Council has kept interest rates steady, with the minimum bid rate on the main refinancing operations remaining at the historically low level of 2.0%. Since the second half of 2003 prospects for a gradual economic recovery have brightened. However, as a consequence of adverse food price developments and higher oil prices - although the latter were attenuated by the appreciation of the euro - it was only in early 2004 that inflation fell below the upper ceiling of 2% laid down in the definition of price stability.

In line with the medium-term orientation of the ECB's monetary policy, interest rate adjustments in response to economic shocks have generally been made gradually, thereby avoiding frequent shifts in the ECB's policy stance. This non-activist policy has contributed strongly to stabilising medium-term interest rate expectations in accordance with the definition of price stability. It has also ensured that, in the face of strong share price fluctuations resulting from the initial new economy euphoria and the subsequent disillusionment, monetary policy has not itself become a source of destabilising expectations. This has helped to anchor long-term inflation expectations at levels consistent with price stability. The medium-term perspective of the ECB's policy is also indicated by the fact that the Governing Council decided to lower interest rates in May 2001 - i.e. at a time when consumer price inflation had just peaked and real growth rates for the previous few quarters were still robust.

Did this monetary policy strategy prove to be a success in the first five years of its existence? Has confidence in the ECB's ability to fulfil its mandate strengthened? Of course, one measure would be to look at developments in the HICP. In fact, the average annual increase in the HICP over the first five years was slightly below 2%, despite substantial adverse price shocks that occurred during that time. Another measure of the ECB's success can be derived from developments in long-term interest rates, reflecting market expectations for long-term inflation risks. For example, developments in French HICP-indexed bonds[23] show that since the beginning of Monetary Union long-term inflation expectations have been anchored at levels consistent with the definition of price stability. This, I believe, can rightly be regarded as an indication of the high degree of credibility enjoyed by the ECB.

Communication between the ECB on the one hand and the financial markets and the general public on the other has - especially at the start of the single monetary policy - not always been without difficulties. However, it is clear that communication between the ECB and both the public and the financial markets has improved considerably over time. So, too, has the public's understanding of the ECB's strategy. For example, some commentators initially confused the reference value with a monetary target and assumed that the ECB was pursuing a monetary targeting strategy, while others implied that it was pursuing an inflation targeting strategy on the basis of an inflation forecast or even a mixture of both. Such misinterpretations have since become rare.

Since the ECB's inception the institutional framework for securing a stable European currency and lasting economic success has proved itself in practice. None of the fears mentioned above has materialised. However, for the benefits of a stable single currency to be reaped in full by all participating Member States, a number of challenges have yet to be met. The ECB has emphasised time and again that the single monetary policy remains handicapped by the existence of considerable structural rigidities in the European Union. As much has been left undone in recent years, it is now more crucial than ever to implement structural reforms in order to improve the growth potential of the euro area economies. This would also strengthen their capacity for responding appropriately to macroeconomic shocks.

Significant challenges also lie ahead in the area of fiscal policy. This is perhaps the area in which the need for sound macroeconomic policies and for structural reform are most closely related. In particular, primary expenditure needs to be restrained in order to finance further consolidation and reduce high tax burdens without undermining the sustainability of public finances.

In view of the enlargement of the European Union, it is more important than ever that governments be mindful of their own particular responsibility and thereby help to ensure lasting prosperity.

[23] See ECB, 2003b, p. 33.

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