Klaus Liebscher: Challenges for the Eurosystem's monetary policy

Contribution by Dr Klaus Liebscher, Governor of the Oesterreichische Nationalbank, to the panel discussion on monetary policy, 28th Economics Conference of the Oesterreichische Nationalbank, held in Vienna, on 15 June 2000.

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Ladies and gentlemen!

Central bankers are used to acting under uncertainty - in fact, this is a major rationale for their existence. The Eurosystem - i.e. the ECB and the euro area national central banks - has undergone - and, I believe, successfully passed - a special test on "Monetary policy under uncertainty" in managing the transition to EMU and in conducting monetary policy during the first one and a half years of the euro area's existence. Indeed, EMU represents a major regime shift, with a number of associated uncertainties, such as data uncertainties, uncertainties about the monetary transmission mechanism across the euro area, uncertainties about the economic structure of the euro economy as it is adapting to the new, more competitive environment, and, last but not least, uncertainties about the interaction between the various economic policymakers.

Ladies and gentlemen, let me contribute six observations to the issue of our panel discussion which were obviously similar.

The first observation relates to the role of monetary policy in a situation when the economy is possibly entering a new era. Some proponents of the New Economy claim that monetary policy should be relaxed to "give growth a chance". Now, while I certainly have sympathy with economic policies supporting economic growth, employment and welfare, I think this categoric claim is beside the point. Monetary policy should always and unambiguously - with or without a "New Economy" - pursue its primary objective of maintaining price stability. A stable anchor for price expectations is particularly important in a period of heightened uncertainty. It is common wisdom by now that, by credibly sticking to price stability, monetary policy serves growth best. Indeed, it has been argued - and I would subscribe to this assessment - that the low inflation of the 1990s was among the contributing favorable framework conditions which laid the ground for the recent emergence of dynamic entrepreneurship and innovation in the United States. In addition, the highly competitive and far less regulated market structure of the US economy has contributed substantially to new businesses and new technologies.

This does, however, not mean that monetary policy should be blind and ignorant vis-à-vis the changes brought about by a New Economy. Quite on the contrary!

This brings me to my second observation, ladies and gentlemen. In a situation of uncertainty about a regime change, the central issue for monetary policy is: on which economic indicators best to focus in order to assess inflation prospects. And it is with these indicators - not with the policy objectives - where shifts of weight might be appropriate.

Any regime change may have the unwelcome effect of altering long standing economic relationships. The advent of a New Economy affects a number of variables which the central bank would normally monitor to assess whether the economy is below, at or above its potential and whether therefore inflationary pressures are likely to emerge. A New Economy would, by definition, increase the economy's potential output, so potential output and any concept directly or indirectly derived from it - such as the output gap, NAIRU (i.e. Non-Accelerating-Inflation Rate of Unemployment) or the natural rate of unemployment and growth - become less reliable indicators of future price developments.

Thus, the central bank should attach less weight to these indicators in periods where fundamental changes to the trend growth of potential output are suspected. At the same time, the potential break in long-standing economic relationships means that quantitative models, which are usually estimated from long time series, become a less reliable guide for the interpretation of current and future economic developments. Thus, by necessity, the central bank should attach more weight on a detailed analysis of current economic developments.

Ladies and gentlemen, this leads me to my third observation. The Eurosystem's two-pillar monetary policy strategy was particularly chosen to cater for a period of transition and uncertainty, although - to be frank - at the time of designing this strategy, we certainly did not have a New Economy in mind but had quite different concerns. The two-pillar strategy allows us - and compels us - to follow closely and systematically a wide range of monetary, economic and financial indicators which may give indications on future inflation and economic developments at large. It easily accommodates the advisable shift in the relative weight attached to various variables which I advocated previously.

What is more, the two-pillar strategy does not pretend the existence of certainty and stable economic relationships where there are in reality no such things. In this sense, it is a very honest strategy. To be transparent to the public, though, it requires special communication efforts by the central banks.

By all means, the two-pillar strategy is in my conviction clearly superior - particularly at the present juncture of considerable model uncertainty - to any mechanical rule-based approaches. The latter are usually tailored to specific views of how the economy operates and are therefore less likely to perform well in periods where these views might have to be adapted. Monetary policy rules usually derive their policy recommendations from a very narrow set of economic indicators only. In many cases they rest heavily on the output gap and the equilibrium real interest rate, which, as I have pointed out, are potentially very unreliable concepts at the present juncture.

Ladies and gentlemen, let me now, as my fourth observation, address the issue of how a New Economy would influence monetary policy in the long run, in other words how it would affect the long-term prospects for real interest rates. Again, there is unfortunately no simple answer.

Even in the United States, where recent data clearly point to a substantial increase in the growth rate of productivity, it is still open whether a New Economy would permanently increase the trend rate of productivity growth or, alternatively, cause a one-off shift in the level of productivity only.

What is more, even in the latter case of a one-time level shift in productivity, it could take the economy quite some time - up to a decade or more - to reach its new steady state. It will therefore also in the near and medium-term future remain unclear which of the two effects the ICT revolution entails.

Ladies and gentlemen, let me now, as my fifth observation, turn to the more immediate period of the transition to a possible New Economy. As has recently been pointed out by Alan Greenspan, the potential problem for monetary policy from the New Economy is that the pick-up in productivity may create even greater increases in aggregate demand than in potential aggregate output. So, in other words, monetary policy needs to closely watch the relative size - and the timing - of the potential effects on aggregate supply and demand. Let me elaborate a little bit on this. I am close to what was said by President Broaddus and Governor Bäckström.

The prospect of higher productivity, higher economic growth and thus higher profits may boost stock prices particularly of firms operating in the new ICT sectors, as we have observed in the past few years. The associated stock price rally increases consumers' financial wealth.

At the same time, current high labor demand and the generally optimistic outlook on the economy may increase workers' expectation of their future salaries, and thus also increase human wealth. Taken together, this may boost consumer spending even ahead of, and in excess of, the growth effects actually materializing. In this case, the temporary excess demand would spur inflation, and monetary policy should intervene in order to cool off demand to a pace consistent with the increase in the economy's productive capacity.

By contrast, if demand and supply effects from a New Economy developed broadly in parallel, monetary policy could pursue a neutral stance. This does not mean that the central bank should keep nominal short-term interest rates constant. Rather, it should see that overall monetary conditions, including the exchange rate and long-term interest rates, remain neutral.

It also follows from what I said before, that monetary policy should not try to target a specific level of stock prices or to put a lid on stock prices. Particularly in an era of a potential substantial regime change, it is impossible to judge with any confidence on the appropriate level of stock prices. Monetary policy should, however, take into account the current - and potential future - aggregate demand effects arising from rising - and potentially falling - stock prices.

Concluding, ladies and gentlemen, let me finally observe that the factors behind the New Economy applicable to the US could also have a similar positive effect on Europe.

As regards technology, as I already pointed out in my opening remarks, there is the chance for Europe - based on the US experience - to achieve good results. A second argument consists in the benefits of the European integration into the global economy and the advantages of the Common Market - like deregulation in areas such as telecommunications and in the public utilities sector. Finally, the establishment of the Monetary Union forces a restructuring in the corporate sector and facilitates new economic policies.

All in all, the latter requires a much stricter approach on the European level to abandon rigidities in the labor, goods and services markets, to create a more favorable environment for entrepreneurship and to improve the structures and techniques of the risk capital markets.

Compared with the situation a few years ago, we are heading forward in these crucial areas. Therefore, I am very much convinced that Europe has also the potential for a New Economy if we are willing to adopt the process of further structural reform. But there are many and good reasons for optimism. An important one is the well-functioning Monetary Union, which opens up many opportunities.

Thank you very much for your attention.

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