Jürgen Stark: Future trends in central banking

Dinner Speech by Dr Jürgen Stark, Deputy Governor of the Deutsche Bundesbank, at the Conference "The next 25 years in African Economic Development", Bank of Botswana, on 6 July 2000.

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Your excellencies, ladies and gentlemen,

It gives me great pleasure to convey the congratulations of the President and the entire Deutsche Bundesbank on the 25th anniversary of the founding of the Bank of Botswana. I am aware that the Bank of Botswana, with its stability-oriented monetary policy - the conditions for which were improved still further in 1997 following the modernisation of the Bank of Botswana Act - has for years been making a substantial contribution to the much above-average performance of the Botswanan economy in Africa, even if a number of structural adjustments still need to be made. With its responsible budgetary policy and well-developed democratic system, Botswana is a widely-rated model for Africa.

"Who does not know the past, will not come to terms with the future",[1] said Golo Mann, a well-known German historian and publicist, some years ago. That statement is also true of the future of central banking. Let me therefore start with a brief look back at the recent history of central banking as a starting point for highlighting some aspects of the challenges that will face us in future.

In the middle of the 20th century, after the end of the Second World War, Germany - perhaps more than any other country - was searching for a new economic policy paradigm that would mark out a course for the future. At that time, a decision was made (at least in the western part of Germany) in favour of implementing ***free market principles***. That decision - as the *Wirtschaftswunder*, Germany's much-cited "economic miracle" showed - was to produce notably successful results.

Apart from those fundamental policy decisions that set the future course for a market economy, however, that notable success was also due to an unqualified ***commitment of monetary policy to the objective of price stability***. Following the devastating experience of war inflation, and after the subsequent currency reform, the parliament of the young Federal Republic of Germany made that price-stability objective the primary task of the newly established central bank. This decision was anything but a matter of course at a time when Keynesianism was shaping economic policy thinking not only in most other industrial countries but also in the Federal Republic of Germany itself. The Federal Republic's monetary approach and the perception of the Bundesbank's role and task acting together with those who bear political responsibility were - as we are now aware - far ahead of their time.

That is true not only in terms of the primary commitment to the objective of price stability but also with regard to the instruments and the regulatory framework in which the central bank acted. The central banks and governments in most industrial countries were placing their trust in the administrative management of monetary and financial activity by attempting to influence financial flows - domestically, by means of selective credit controls and interest-rate regulations and, externally, by imposing capital controls. In the Federal Republic of Germany, by contrast, the opening-up of borders for capital movements and the liberalisation of interest rates began at an early stage. At that time, the foundations were laid for the D-Mark's subsequent reputation and attractiveness, which was to make the young German currency the second most important international investment and reserve currency next to the US dollar - something which happened more quickly than seemed desirable in the light of financial markets which were then still "underdeveloped" in some respects.

[1] "Wer die Vergangenheit nicht kennt, wird die Zukunft nicht in den Griff bekommen"

How much ideas about an efficient monetary policy varied within the group of industrial countries during the post-war period became very clear in the seventies. Economic policy thinking at the time was that a given level of output - and thus full employment - could be achieved at any time if only the right mix of monetary and fiscal policies were to be deployed. Inflation was understood more as a "lubricant" of dynamic economic growth and not as an undesirable development which, in the longer run, results in severe losses of growth and welfare. It took until the end of the seventies before there was a broad acceptance of the bitter finding that unemployment cannot simply be combated by higher inflation. The markets quickly saw through the fact that monetary policymakers were playing with the money illusion of the market participants - on which the Keynesian approach relied.

In effect, monetary policy in many countries at the end of the seventies was faced with the "wreckage" of high inflation and high unemployment as well as growing losses of credibility. In many cases, the Keynesian experiment was bought at a high price.

In the light of those realisations, there was a fundamental ***paradigm change in monetary policy*** in the later seventies and early eighties in favour of an approach unambiguously geared to price stability. At the same time, the set of monetary policy instruments was brought more closely into line with market conditions, and interest rates in the financial markets as well as cross-border capital transactions were liberalised. This sea change in monetary policy was accompanied by a general reorientation of economic policy which compelled the government to concentrate on its primary functions, thus creating greater scope for the development of market forces. This reorientation of monetary policy has not been without success. During the past twenty years, inflation has been reduced to a much more acceptable level in the industrial countries, thus making it possible to speak at least virtually of price stability in the majority of countries.

Over the past few decades there has arisen an international consensus about monetary policy that is geared to price stability. The evident success of such a policy in the nineties paved the way for a single monetary policy in Europe. As a result, with the start of ***European monetary union*** at the beginning of 1999 the conditions for tension-free broad-based growth have improved.

The experience of German monetary policy and that of other central banks has taught us that, besides the unambiguous commitment to the objective of price stability, the independence of the monetary policy decision-makers is a basic precondition for that success. Independence means, first of all, that the central bank is independent of the government in formal terms with regard to the deployment of its monetary policy instruments. The Maastricht Treaty provides the European System of Central Banks with an even greater degree of independence, in fact, than was stipulated earlier by the legislators of the Bundesbank Act. The central bank's formal independence of the government has to be accompanied by material independence which ensures that the monetary policy decision-makers can take their decisions in isolation from the interests of the government. For that reason, the agreements on European monetary union provide for terms of office for the ECB's management that are of adequate length and rule out premature dismissal. Furthermore, the independence of monetary policy in Europe is protected by the Maastricht Treaty prohibiting the ECB from financing budgetary deficits and by the fact that the exchange-rate arrangements of the governments are clearly subordinated to the primary objective of price stability.

After roughly 18 months, in which responsibility for monetary policy has resided with the European Central Bank, it is undoubtedly still too early for an overall assessment. However, the fact that the changeover to the euro took place so smoothly can already be put down as a success. Moreover, the interest-rate decisions of the ECB Governing Council since last autumn have demonstrated the promptness and determination with which the ECB is countering signs of inflationary tensions. We may be confident that the central banks participating in EMU and the ECB constitute a reliable bulwark against inflation. In saying that, we have to guard against misconceptions. The danger of inflation is not dead simply because the current statistics are showing comparatively stable prices for most of the industrial countries. The fight against inflation will not have been won until inflation has disappeared once and for all from the range of attractive policy options. The struggle to create a stable environment remains the prime task of the central banks.

Does that mean “business as usual”? No, that is certainly not how I see the ***future of central banking***. The increasing globalisation of the markets and the resulting structural changes mean that the central banks are facing challenges on a scale that cannot easily be grasped at present. It is possible that we shall be forced to recognise that the move in monetary policy towards instruments that are more in line with the market - which was, in principle, very much welcome - may cause difficulties that we cannot yet properly assess in an environment in which market conditions have changed. What will be the implications, for example, if the traditional funding of enterprises by credit institutions is increasingly replaced by funding through other financial intermediaries and from other sources, such as insurance enterprises and securities issues, which are not subject to direct monetary policy control? And what will be the implication for monetary policy if the term “money stock” simply slips out of our grasp because no one is able to say any longer with any certainty what money is or what it is not? Just think of the possibilities of the Internet and the increasing use of electronic money. What repercussions will this have on the transmission channels of monetary policy and, by extension, on the effectiveness of monetary policy?

Above all, the ***fiercer competition in the financial markets*** and the increasing blurring of boundaries between money and other financial assets, and between banks and non-banks will reduce individual institutions’ scope to set their own interest rates. In other words, in future it will be more difficult for the banks to pass on the central bank’s interest-rate moves to their customers with a time lag or only to a limited extent. This is likely to result in monetary policy stimuli being transmitted more quickly via the interest-rate channel, which is fundamentally welcome from the point of view of the central bank. Nevertheless, this will bring about changes to the established mechanisms of the transmission process, which might - at least for a time - give rise to certain problems of interpretation for monetary policy. Furthermore, the increasing securitisation of assets means that greater attention will have to be given to the impact of central bank policy on the capital market rate and its implication for the real sector.

But we shall probably have to adjust to the fact that the ***increasing growth and use of the internet*** is opening up new possibilities in the financial sector which are not without risk from the point of view of the central banks. The growing use of e-money in payments may, at times, lead to some problems of data interpretation. As long as flows of e-money are dominated by domestic banks, however, this will not result in any lasting impairment of monetary policy, since we possess the instrument of - by all means, remunerable - minimum reserves. At all events, the existence of minimum reserves ensures that broader monetary aggregates remain closely related to the provision of central bank money. Consequently, it will be important to create the statutory framework for making all enterprises wishing to issue e-money subject to banking supervision and minimum reserve requirements.

The situation would be somewhat different if, say, residents were to use money supplied by a non-resident issuer for domestic transactions on a significant scale. This might loosen the relationship between the national money stock and the domestic transaction volume and cause the money stock indicators to lose some of their informative value. On the other hand, the processing of payments abroad harbours new risks for the market players - risks that make a sharp growth in such arrangements appear, if anything, unlikely on account of differences in the legal frameworks for the guaranteeing of deposits, for example. Thus, it can hardly be assumed that the emerging changes will descend on us abruptly without us being able to respond. The volume of e-money issued is, at all events, still very small at present.[2]

In summary I would like to reiterate three points:

1. There is now a worldwide consensus that monetary policy - as independent as possible of political influence - should be committed primarily to the objective of price stability. The experience of the industrial countries in the 1960s and 1970s, at least, showed that an

[2] In April, electronic money accounted for no more than 0.05 % of the currency in circulation in Germany and such shares are, if anything, likely to be even smaller for the other countries of the euro area.

inflationary policy only harms the development of the economy. Or to put it another way: price stability is the best precondition for sustained growth.

2. The benefits of the paradigm change that took place in the late seventies and the early eighties are now becoming apparent. Inflation has been largely brought under control and, in most industrial countries, it is more or less already possible to speak of price stability. That does not mean, of course, that we central bankers have to fear that we shall soon become superfluous. Price stability is a good that has to be earned every day anew - vigilance is therefore still the prime necessity for monetary policymakers.

3. But in another respect, too, there is no cause for us to be complacent or satisfied with ourselves and take a back seat. New challenges are on the horizon. I see no occasion for pessimism, however, when faced with the advancing globalisation of the financial markets and intensifying competition in the financial sector: they may call for flexible adjustments and changes but are not a fundamental impediment to an effective monetary policy. Established economic relationships may change or become looser, but this will not prevent monetary policymakers from being effective in performing their task of ensuring the internal stability of their own currency in the future as well.