Nout Wellink: The monetary strategy of the Eurosystem - an assessment

Lecture by Dr Nout Wellink, President of De Nederlandsche Bank and President of the Bank for International Settlements, at the 16th annual Tinbergen Lecture organised by the Royal Society for Political Economy (Koninklijke Vereniging voor Staathuishoudkunde), Amsterdam, 18 October 2002.

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Introduction

The Bank has for some years provided the venue for the Tinbergen Lecture. Apparently, even without the former Palace of Crafts and Industries, this spot at the Frederiksplein has space available for the occasional social activity. The greatest event in this context was the Euro-summit of 1997. And in a symbolic sense, I would be happy to have the Bank move into Wim T. Schippers' palace of crystal: the glass would exemplify the transparency which must characterise a central bank. This is especially true of its monetary policy, for which our Bank, together with the other central banks in the euro area, bears a common responsibility. Transparency promotes a central bank's effectiveness and public accountability. In this spirit, I hope to offer some perspective today on the role of a monetary strategy as pursued by central banks in general, and by the Eurosystem in particular.

The role of a monetary strategy

Essentially, a monetary strategy reflects the way in which a central bank uses its primary instrument, often a short-term interest rate, to realise its objectives. Rather than offering a mechanical decision-making tool, the strategy describes a procedure. It is a guide rather than a cookery book. And monetary strategy not only serves as a guideline for the internal analysis of economic and monetary developments; it also provides a framework for external communications.

In the case of the Eurosystem, the short-term interest rate is employed in the pursuit of a single objective. This is the primary objective of a low and stable inflation rate, in other words price stability, in keeping with Professor Tinbergen's famous dictum that a single instrument cannot be used to pursue diverging objectives. Yet some central banks aim to stabilise real GDP growth or employment, as well as achieving price stability. The American Fed is a case in point. The coexistence of dual objectives and a single instrument may be understood in two ways. First, a central bank may pursue what it perceives as the most favourable combination of inflation and growth stability, without fully realising either. Alternatively, objectives which conflict in the short run may coalesce over time. In ensuring low and stable inflation, a central bank contributes to sustainable and balanced growth in the medium term.

Price stability also has a normative side, in that inflation or deflation result in the redistribution of income and wealth without democratic legitimisation. The weaker groups in society are particularly ill-equipped to defend themselves against this. My predecessor, Jelle Zijlstra, dwelled at length on the social dangers of inflation in a 1975 article for the Economist. If inflation is not combated effectively, to quote Zijlstra's words, then "the principles of private enterprise and of democratic government will not be able to survive". Fortunately, nowhere in Europe is inflation such a threat as it was in the 1970s. Yet the unrest over the inflationary movements caused by the introduction of the euro banknotes and coins shows that even at relatively low rates, inflation is perceived as unjust and hence must be counteracted.

Before discussing the stronger and the weaker points of the Eurosystem's monetary strategy, I would like to make a qualifying remark. Just as many roads lead to Rome, so many strategies lead to price stability. Some academics would have us believe that the macroeconomy can be adequately described by a small number of equations, and they proceed to determine the optimal policy strategy by applying mathematical techniques. I wish things were that simple in practice. Even in 1832, the Prussian military theorist Carl von Clausewitz, in his authoritative work On War, remarked that a military strategy cannot be summarised in a simple rule. On the battle-field unexpected things happen all the time. Similarly, a central banker is confronted on a daily basis by the complexity of the economy and by unexpected events. This is the most important reason why a strategy is used in a procedural way for reaching monetary policy decisions, and is not used as a fixed rule.

Monetary objectives and strategies differ less from country to country than is often thought. This is especially true in the current situation of low and more or less stable inflation rates. Policy decisions are sharper in nature during times of monetary crisis, whether amid high inflation, as in the days of Zijlstra's presidency, or amid deflation, as in Japan today. It is in such times that differences between central banks come to the fore.

The unique character of the Eurosystem's strategy

Concerning its decision-making, the Eurosystem's monetary strategy has clearly been successful. The inflation rate in the euro area since the start of Stage Three of EMU has averaged 2%, precisely the upper limit of price stability. We are at this limit because of a sequence of inflationary shocks. Fortunately for the longer term, expected inflation rates remain low, at somewhat below 2%.

The Eurosystem's strategy is different from that of other central banks. It is made up of a quantitative definition of price stability plus two pillars. Price stability is defined as a year-on-year rise of the harmonised consumer price index of less than 2%. Price stability is to be maintained over the medium term. Deflation is expressly inconsistent with this definition of price stability. Deflation is, particularly in combination with a fall in demand, at least as damaging as inflation. Persistent deflation, in combination with the fact that nominal interest rates cannot be negative, reduces the manoeuvring room for monetary policy. Moreover, deflation increases the real indebtedness of debtors.

This definition reflects a desire to secure inflation expectations on a low level without, however, promising greater precision than can be achieved given the uncertainties in economic developments. In practice, we prefer an inflation rate roughly between 1% and 2%. Sometimes arguments are raised in favour of stretching the price stability zone to 3%, as a target rate below 2% is seen as overambitious. These arguments are based on the misconception that a price stability definition implies an inflation targeting goal. Only "inflation targeting" central banks aim monetary policy at a specific inflation target over a specified time horizon. That, therefore, does not hold for the Eurosystem.

Under the so-called first pillar, monetary phenomena are analysed, with the main focus on the movement of the broad monetary aggregate, M3. Empirical data indicate that M3 is a good indicator for prices in the longer term. Like so many relations in the economy, however, this one is also beset by uncertainties. For this reason, money growth is measured against a reference value rather than a target rate such as the Bundesbank used to have. The second pillar consists of the analysis of all other information relevant to future price stability. Both pillars are always considered in tandem. Ultimately, monetary policy decisions are made on the basis of a broad assessment of the risks to euro area price stability. These, very briefly, are the lines along which the Governing Council of the ECB reaches monetary policy decisions.

Our strategy ensures a high degree of continuity with the German Bundesbank's monetary policy. This has allowed the Eurosystem to benefit from the reputation of Germany's central bank. At the same time, the strategy takes account of the fact that monetary authorities are confronted with uncertainty. This is reflected in the broad-based assessment of the risks for price stability, based on both pillars. The uncertainties are greater for the Eurosystem than for other central banks, given the additional uncertainties associated with EMU. The transition to monetary union has changed the behaviour of economic agents, partly because the differences in interest rates that used to exist between the countries of the euro area have almost disappeared.

The most striking element in our strategy is the separate pillar for money in a broad sense. Although we call it the first pillar, this does not in itself mean that it is the most important one. The factors which are decisive in determining the prospects for price stability depend entirely on circumstances. Money growth is, at the moment, not the decisive factor. It has for some time clearly exceeded the reference value and the resulting situation of ample liquidity could, over the longer term, lead to upward inflationary pressures. There is currently little danger of this given the present economic weakness. Although the first pillar may not always be the most important one, money remains the logical starting point for our analysis. As a central bank, the Nederlandsche Bank naturally has closer ties to money than to other sources of inflation. To exaggerate slightly: money is our product, so that is what we first focus on. From a more academic viewpoint, a good case may be made for treating money separately. Macroeconomic models for short-term forecasts usually do not assign a specific role to money, although in a monetary economy, every real transaction is offset by a financial one. Viewing real phenomena from a financial angle therefore often provides new insights.

Our strategy emphasises the fact that monetary factors are important, though not all-important. In the short run, wage developments and other cost factors are of great significance for inflation. In a sense, therefore, monetary policy in the Eurosystem, like that of the Netherlands in former times, may be characterised as "moderate monetarism". Accordingly, the members of the ECB Governing Council take all indicators into consideration. Our procedure ensures that monetary aspects will be considered separately. Some of us attach more importance than others to monetary indicators. What is so attractive about our strategy is that it leaves room to afford greater or lesser weight to the different indicators. In an economy as complex as that of the euro area, this is a sensible approach.

Strategy in practice

In practice, making monetary policy is difficult because the economy is continuously exposed to shocks, the effects of which are sometimes not entirely predictable. One might think of sudden changes in the oil price caused by tensions in the Middle East; of failing crops; or of exchange rate fluctuations. In particular, shocks that push up inflation in the short-term while at the same time reducing output, confront a central bank with difficult policy decisions. A strategy offers a guideline for choosing among the available options.

In this context, some ECB watchers have urged the Eurosystem to direct its policy towards what they call "underlying inflation" instead of unadjusted inflation. In their view, underlying inflation is something of a cure-all. By assigning a central role to this concept of inflation, the Eurosystem would, as it were, be able to see through the direct impact of a shock on prices. The usual method to arrive at underlying inflation is by disregarding fluctuations of volatile components such as energy and food prices in calculating inflation.

I myself reject a monetary policy explicitly centred on underlying inflation. Like other cure-alls, it is a piece of quackery. Rely on it too much, and it can become life-threatening. There is a real danger that a policy centred on an artefact such as underlying inflation would harm the ultimate goal, which is price stability. The public is not interested in underlying inflation, but in the inflation they can see in their purses. For this reason, the European Treaty is also directed towards maintaining price stability, not towards underlying inflation. Another major objection would be that the categorical exclusion of, say, oil price rises from relevant inflation rate is based on flawed reasoning. Without doubt, oil price rises are often to some extent exogenous. Think of a decision by OPEC to raise prices or of rising tensions in the Middle East. To the extent that such a shock is exogenous, there is little reason to worry about more than the knock-on effect on, in particular, wages. But in many cases a rise in oil prices may also reflect increased economic activity. An oil price increase due to a greater demand for oil requires a different monetary policy reaction than a price increase caused by reduced supply. Underlying inflation cannot offer any clarity regarding that difference. So there are both fundamental and statistical reasons why founding a policy on any single underlying measure of inflation would be to court disaster.

Although rejecting a central role for underlying inflation, the Eurosystem’s monetary policy still aims to absorb shocks as best it can. External shocks may temporarily push inflation beyond the limits of the price stability zone. This is one of the reasons why our definition of price stability has a medium-term orientation. The other reason is that monetary policy tends to pass through to inflation with a lag averaging some eighteen months. Yet it is very difficult to specify exactly what is meant by the medium term. Lag times vary, and during the time it takes for a policy decision to take effect on inflation, new shocks may occur. Seen in this light, a temporary inflation rate above 2% is not a disaster, and neither is an occasional fall in the price level. But eventually, the Eurosystem will have to deliver the goods, that is, price stability. That is the foundation on which the Governing Council renders account of past policy.

The Council makes its decisions jointly. The responsibility for price stability is shared by all members. So far, the Council has never voted over its interest rate policy, which points to a high level of consensus. But this emphatically does not mean that everyone has always agreed on everything, which in itself is a good thing. Consensus only implies that all members of the Council have been able eventually to go along with every interest rate decision. Has consensus slowed down monetary policy decision-making? No, it has not. The reason why is that the Governing Council, although eighteen members strong, is homogeneous in character: members share a preference for price stability. Consensus-building has been strongly supported by the obligation under the Treaty to work towards price stability.

Communication

If we look at the bare figures, monetary policy has been a success, as I have already noted. Yet, communicating it has not always been straightforward. Several aspects may be distinguished. On each of these aspects, however, progress has been made over time.

In the first place, policy decisions have not always been correctly understood by the public. This is not very surprising, since the Eurosystem is a new institution with a new monetary strategy. However, now that it has come into its own, after a few years, this problem has begun to disappear, simply because the public has become more accustomed to our approach. A great help in this respect was the decision to halve the frequency of meetings where monetary policy is discussed to once every month. This has also reduced the extent of speculation over impending interest rate adjustments.

In the second place there was – apart from the occasional communication error – too much communication sometimes, especially in the early days. This may sound paradoxical, but what counts is optimum, not maximum, communication. Too many messages do not enhance transparency, especially if they convey what seem to be contradictions. For this reason, the Governing Council has agreed that in the run-up to each monthly meeting, radio silence will be observed about developments with a direct bearing on monetary policy.

Thirdly, communication is a complicated matter if one wishes to be as open as the ECB. Although it does not publish minutes of its meetings, the ECB is the only large central bank which holds a press conference directly after every decision, to explain its motives. At the same time, a communiqué is published enumerating the considerations which have led to the decision. Compare this to the sober comments by the Bank when it pursued its independent monetary policy, pegging the guilder to the Deutsche mark. We used to confine ourselves to phrases like: "Domestic and foreign developments considered, the Nederlandsche Bank has decided to lower the interest rate on advances by 0.25% to 5.25%." The question pondered these days is how the Eurosystem's press releases may provide even more clarity on the considerations leading to interest rate decisions. This has been an ongoing issue. Having said this, it would not be very useful to publish individual members' views on interest rate policy. A single person may simultaneously harbour considerations in favour of and against a specific decision. Besides, in the European context there would be the risk that views of individual Council members could be linked erroneously to the economic situation in their home country. What ultimately matters is the credibility of the Eurosystem as a whole and publishing the opinions of individual Council members would add little, if anything, to that.

To sum up, the monetary strategy of the Eurosystem offers a sound framework for economic and monetary analysis; it has been effective, in my experience, in guiding the monetary decision-making process within the Governing Council of the ECB. The results are favourable, considering current and expected inflation. There have been occasional communication problems, caused in part by the fact that the ECB is such a young institution with a unique monetary strategy. I record with satisfaction that here, too, there is less and less confusion. The strategy will be further refined as we learn from our experiences and from academic insights. The manner in which we achieve the aim of price stability may, if necessary, be adjusted; the aim itself, however, stands carved in stone. Right now, we are well-satisfied with the current strategy. Its flexible character makes it ideally suited to accommodate the accession to EMU of new Member States. The strategy can always be explained more fully, of course. I hope that I have made a contribution in this respect today.