Axel A Weber: The independence of the central bank and inflation – the Bundesbank example

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Narodowy Bank Polski (National Bank of Poland), Warsaw, 26 October 2006.

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1 Introduction

Dear President Balcerowicz, ladies and gentlemen

It is a great pleasure for me to be in Poland, in general, and in Warsaw, in particular. Warsaw is an impressive and fast-moving city.

When coming here, I saw many reminders of Poland's successful transformation from what used to be a centrally planned economy into one that is market-driven.

A transformation of this kind is anything but easy as can be seen not only in Poland, but also in many other transforming countries in central and eastern Europe.

All of these countries experienced more or less severe initial recessions in the transformation process during the early to mid-1990s, with per capita GDP dropping below levels witnessed during the era of central planning.

Poland, however, was able to benefit rather quickly from the introduction of market mechanisms into its economy. Hence, it became the first country in the region to exceed the GDP levels recorded at the end of the socialist economy.

Evidently, Poland has so far been more successful than other countries in managing the challenges of the transformation process.

One key architect of this success story is undoubtedly my colleague Leszek Balcerowicz, who, in 2005, was awarded Poland's highest decoration, the Order of the White Eagle, reflecting his contribution to Poland's transformation.

When Leszek asked me to deliver a speech here in Warsaw, I did not hesitate for a moment. Indeed, it is a pleasure for me to share my thoughts with you on a topic that is of the utmost importance for the stability of a currency.

Over the next 30 minutes or so, I shall mainly elaborate on the nexus between central bank independence, inflation and economic performance.

In doing so, I will occasionally refer to the history of my own institution, the Deutsche Bundesbank. However, in most of cases, I shall focus on the independence of the European System of Central Banks (ESCB) in order to give you specific examples from the present day.

Over the past few decades, a well-founded consensus has emerged about the nature of sound monetary policy. This consensus comprises the following two key elements.

- The clear assignment of responsibility for inflation to an independent central bank.
- Agreement that inflation should be low and stable. Thus, maintaining price stability should be a central bank's primary objective.

Irrespective of the many studies supporting the rationale behind his consensus, politicians, in particular, tend to question central bank independence and the benefits of price stability from time to time. This is rather worrisome, since both elements constitute the foundation on which successful economies are being built.

Against this backdrop, I therefore wish to elaborate on both these aspects in the course of my speech. I shall aim to point out the reasons why central bank independence is a prerequisite for price stability and why price stability, in turn, is conducive to fostering sustainable, non-inflationary economic growth.

2 The independence of the ESCB

2.1 Institutional arrangements

In the European monetary union (EMU), the independent central banks of the ESCB share a common responsibility for the single monetary policy. But what is actually meant by the term "central bank independence"? In this context, it refers to four different aspects of the special institutional arrangement which characterises the ESCB.

First and foremost, the most important aspect of central bank independence in the euro area is that the central banks of the ESCB are independent of political instructions, an aspect referred to as institutional independence [laid down in Article 108 of the Treaty establishing the European Community]. Neither the ECB nor the national central banks, nor any member of their decisionmaking bodies are allowed to seek or take instructions from Community institutions or from any government [Art. 108 of the Treaty, first sentence].

In turn, the Community institutions and member states' governments also have to respect this principle and must not seek to influence the decisionmaking bodies of the ECB or the national central banks [Art. 108 of the Treaty, second sentence].

This fundamental principle insulates the decision-making bodies of the ESCB from undue political influence while carrying out the tasks and duties conferred upon them by the Treaty.

The second aspect is that of personal independence. Governors of the national central banks are appointed for at least a five-year term of office, members of the ECB's executive board for an eight-year term (with no possibility of reappointment). In addition, members of the Governing Council cannot be recalled for political reasons.

Both arrangements limit the possibility of exerting political pressure on individual members of the Governing Council and, indirectly, on the council as a whole.

The third aspect is that the central banks of the Eurosystem are also independent in financial terms. This means that they are not dependent on funds being provided to them by other institutions in their respective countries. This also helps to protect central banks from political pressure that might otherwise be placed on them, for example, by limiting the banks' financial capabilities.

Finally, the fourth aspect of central bank independence in the ESCB is functional independence. The ESCB's primary objective – to maintain price stability – is enshrined in the Treaty establishing the European Community. Without prejudice to this objective, the ESCB shall support the general economic policies in the European Union. This ranking restricts the scope for potential conflicts that might arise if the ESCB were obliged to pursue different or even conflicting objectives at the same time.

As a result of this transparent prioritisation, monetary policy is clearly geared towards maintaining the intrinsic value of money and, hence, becomes more credible as well as more predictable.

2.2 The rationale behind central bank independence

The independence of the ESCB is enshrined in the Treaty establishing the European Community and the relevant protocols. This independence is very well protected since any amendment to the Treaty requires a unanimous decision from all member states.

But why is central bank independence of such great importance for a stability-oriented monetary policy? What is the reason for the unique institutional arrangement of the ESCB central banks?

First and foremost, the independence of a central bank is not an end in itself. Rather, central bank independence helps to…

- maintain a long-term stability orientation of monetary policy by insulating decision-making bodies from short-term-motivated political influence…
- and, thus, contributes to enhancing monetary policy's credibility, which can be measured by inflation expectations, for instance.

Suffice it to say that the importance of central banks' independence for the maintenance of price stability can scarcely be overestimated.

In this context, the track record of my institution, the Deutsche Bundesbank and its former currency, the D-Mark, is a good example of central bank independence definitely being conducive to maintaining price stability.

The credibility-enhancing effect of the Bundesbank's independence was probably best encapsulated by Jaques Delors, who in the 1990s famously remarked that "Not all Germans believe in God, but they all believe in the Bundesbank".

This remark has to be taken with a pinch of salt, but there are other examples which support the strong connection between independence and monetary stability. Many empirical studies demonstrate that central bank independence allows the monetary authority to pursue price stability more diligently, resulting in lower and less variable inflation.

In brief (with respect to maintaining the intrinsic value of money): institutions – in other words, independent central banks – are of key importance. Hence, central bank independence is an essential requirement for monetary stability.

Therefore, all countries wishing to join the European monetary union are required to ensure the compatibility of national legislation – including the statutes of their national central banks – with both the Treaty and the Statute of the ESCB. This particularly applies to central bank independence.

However, independent monetary policy alone cannot adequately ensure a currency's intrinsic value in the long run.

As a general principle, a stability-oriented monetary policy must be accompanied by a stability-oriented fiscal policy. The reason for this nexus is that unsound fiscal policies generally entail the risk of a conflict between monetary and budget policy.

Given high levels of public debt and associated high interest rate expenses, it cannot be ruled out that politicians will tend to exert pressure on the central bank in order to make it lower the real burden of public debt by easing monetary policy and, thus, allowing inflation to rise.

Although, in general, central bank independence countervails undue political influence, it does not itself solve the potential for conflict which can harm the credibility of monetary policy. Consequently, fiscal discipline is not only a complementary condition of monetary stability, but also of overall macroeconomic stability.

Given the potential problems associated with fiscal imbalances, the avoidance of excessive deficits represents an essential prerequisite for the maintenance of fiscal policies conducive to monetary and overall macroeconomic stability.

The need for sound fiscal policies is especially evident in a monetary union if negative spill-over effects from one member state's budget to the rest of the union are to be avoided.

This is the rationale behind the existence of the excessive deficit procedure – laid down in the Treaty establishing the European Community and further clarified in the Stability and Growth Pact (SGP) – which aims to limit the risks to price stability that might otherwise arise from national fiscal policies.

Finally, having outlined the importance of sound fiscal policies, I would like to emphasise that central bank independence contributes most effectively to monetary stability when it is supported by an overall stability consensus among the general public.

This has been the case in Germany for many decades. Political attempts to undermine the Bundesbank's independence and its pursuit of price stability have been repeatedly rejected by the public.

Let me give you one famous example, namely the public reaction to a speech in 1956 by the then Federal Chancellor, Konrad Adenauer.

In what became known as his "guillotine speech", Adenauer criticised the policy of the Bank deutscher Länder – the forerunner of the present-day Bundesbank – following the Bank's decision to continue a restrictive monetary course.

Adenauer described the Bank's decision as *"a heavy blow … struck at the German economy, and it is the little ones who will suffer most … the guillotine falls on the average man in the street, and that is what grieves me so much."*

However, the response in Germany was highly damaging to Adenauer. The media as well as the public overwhelmingly came out in support of the Bank.

The success of the Bank deutscher Länder in its conflict with Adenauer over interest-rate policy in 1956 was of great importance in reinforcing the de facto independence of the German central bank.

2.3 Central bank independence and accountability

The extensive independence granted to the ESCB means that the central banks in the euro area are not even indirectly subject to electoral accountability. Some people might ask how this can be reconciled with the principle of accountability, which is a constitutive element of every democracy.

This is a reasonable question – the answer to which is that the fact of a central bank being independent does not mean that it is unaccountable.

Indeed, independent central banks, such as those in the ESCB, are accountable to the public in that they have to fulfil their mandate to maintain price stability.

If the Eurosystem were to fail to fulfil its mandate, it would have to explain to the public at large why this had happened. There are various appropriate ways of communicating our policy.

- We explain our monetary policy decisions every month in real time in the opening statement and in the Q&A session with journalists and, thus, explain them, indirectly, to the general public.
- Furthermore, there is the public dialogue during the regular quarterly meetings between the ECB president and the European Parliament.
- In addition, all 18 members of the Governing Council frequently give public speeches, such as the one I am delivering today.

In order to ensure that this form of dialogue and accountability functions smoothly, central bank policy has to be transparent and the central bank has to communicate consistently with the public.

Accountability, transparency, and communication are therefore rightly seen as complementary elements to the independence of modern central banks.

In other words: the need for accountability on the part of independent central banks calls for transparency in monetary policy and consistent communication with the public.

I will now list the crucial elements of a transparent monetary policy, such as that pursued by the Eurosystem:

- A clear definition of the ultimate goal
- Communication of the monetary policy strategy
- Publication of the data used in decision-making
- Consistent substantiation of policy decisions.

In the context of transparency, I would like to make a few additional remarks. It is not only the need to hold the central bank accountable that makes a transparent monetary policy worthwhile. Central-bank transparency also helps to anchor inflation expectations more effectively.

The importance of this aspect can hardly be overestimated. Ultimately, a central bank’s objective is to anchor inflation expectations at a level that is consistent with price stability.

Some researchers such as Michael Woodford, a highly renowned US-based researcher, even puts it as follows, “*Not only do expectations about policy matter, but, at least under current conditions, very little else matters*.”

Even if one does not share this view absolutely, inflation expectations are undoubtedly a crucial measure of a central bank’s performance and its credibility. At the end of the day, monetary policy is perceived to be successful when people’s decisions about savings, investment and consumption are not influenced by a fear of inflation.

3 The benefits of price stability

As outlined above, central banks must be independent in order to pursue the objective of price stability effectively.

However, some people doubt that price stability should be monetary policy's primary objective. In fact, they would like the central bank to simultaneously pursue other objectives, such as economic growth and job creation.

Others even claim that maintaining price stability impedes economic growth. In their view, the objective of preserving the intrinsic value of money should come second to the objective of fostering growth.

I could not disagree more.

Why should price stability actually be an *impediment* to growth and the economic and social development of society? In my view, quite the opposite is true; in actual fact, maintaining price stability is the best contribution which monetary policy can make to sustained economic growth and job creation.

Let me explain the main reason for this conclusion. A monetary policy geared towards price stability reduces the level and variability of inflation and, thus, facilitates the efficient allocation of resources, which is the basis of any sustained economic development.

In addition to this main benefit, maintaining price stability also minimises other negative effects that accompany inflation. To show this, let me briefly elaborate on the costs of inflation, which will clearly explain why price stability should be monetary policy's primary objective.

First, inflation distorts the price mechanism. In a market-driven economy, freely moving market prices are the key signals that indicate scarcity of goods and services. By indicating scarcity, relative market prices help to allocate economic resources to the most productive utilisation.

Inflation, however, distorts this mechanism since the rapid increase of the general price level blurs the signal function of the movement in relative prices. As a result, resource allocation becomes suboptimal, with negative repercussions for growth and development.

Second, inflation induces unintentional effects on the distribution of income and wealth. Experience has shown that the holders of financial assets are particularly severely hit by the erosion of the value of money. Their inflation losses are accompanied by matching undeserved and purely arbitrary gains accruing to debtors.

There are many indications that a considerable number of "small savers", in particular, are not fully in a position to protect themselves against inflation-induced financial losses. Hence, price stability fulfils a crucial social function: It protects the "man on the street", in particular, from being gradually dispossessed by creeping inflation.

Finally, inflation acts as an additional tax. In most countries, tax systems are based on nominal values – in other words, these systems are not adjusted to a rise in the price level.

In such systems, inflation has the effect of an additional tax on investment and labour income and produces considerable wealth losses. The main reason for this is that, in addition to "normal taxation", inflation drives a further wedge between the real yield before tax and after tax. Inflation therefore causes the effective tax burden to increase, a process referred to as "cold progression".

Thus, inflation has significant adverse repercussions not only for growth, but also for income distribution in a society.

In this context, another important consensus has emerged over the past decades. In the long run, there is no trade-off between low inflation and high employment – as a naïve interpretation of the Phillips curve might suggest. A society cannot simply choose to have lower long-term unemployment at the cost of rising inflation.

History has shown that many of the countries that have tried to exploit this alleged connection eventually experienced both: high inflation and high unemployment.

Thus, low inflation and not high inflation, is conducive to fostering sustained economic growth and job creation.

4 Concluding remarks

I would like to sum up as follows: central bank independence is not an end in itself. As a matter of fact, such independence is, instead, a precondition for a stability-oriented monetary policy and helps to enhance its credibility. A monetary policy of this kind keeps inflation contained and inflation expectations solidly anchored.

An environment of low inflation is, in turn, a prerequisite for sustained non-inflationary economic growth. Therefore, a central bank's best contribution to the economic development of a society is to pursue, above all, the goal of maintaining price stability.

It is with good reason that central bank independence and the associated credibility of monetary policy are highly valued.

Thus, governments are, as a general rule, strongly advised not to interfere with a credible and independent central bank, but to value its contribution to overall stability and to the social as well as economic development of the country or region concerned.

In this context, one should always remember that monetary policy credibility, – which is of utmost importance for the stable value of money – is hard won. It can, however, be easily lost, leading to long-term negative repercussions for the overall performance of an economy.

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