Dr. Duisenberg discusses strategies for monetary policy in EMU Address by Dr. W.F. Duisenberg, President of the Netherlands Bank and of the Bank for International Settlements, on the occasion of the Board meeting of the Banking Federation of the European Union held in Maastricht on 20-21/3/97.

It is with great pleasure that I am addressing you on the European Economic and Monetary Union here in Maastricht today, the very location where that Union was pieced together. It was here that we made a concerted effort some five years ago to lay the foundations for the economic and monetary stability of Europe in the 21st century. Since then we have been busily building on these foundations with the result that we now have the outlines of the European Central Bank. The framework for monetary policy contains three main elements: its primary objective, strategy and instruments. Where the first is concerned, there can be no misunderstanding: the Maastricht Treaty prescribes that the overriding objective of ECB policy shall be price stability. Knowing you all to be distinguished financial and monetary experts, I need hardly point out to you that to attain this objective, strategy must be transparent and credible. It is not for nothing that in recent months this issue has been figuring prominently on the agenda of the European Monetary Institute, the precursor of the ECB. Let me give you a brief impression of the consultations held there.

As soon as it has been decided in early 1998 which countries are to take part in EMU, the ECB will decide what monetary strategy to pursue. Generally speaking, there are two aspects to such a strategy: internal decision-making within the central bank and, equally important, the presentation of its measures to the outside world. In fact both aspects hinge on the question which variables should underlie the central banks interest rate policy and what weight should be assigned to each of these variables. After all, monetary policy is complicated by the fact that inflation reacts to the central bank's interest rate decisions with long and varied lags. Actual inflation rates are therefore not cut out to be a gauge of monetary conditions. The central bank should focus on information which provides insight into *future* inflation, and possibly formulate a number of intermediate objectives, the so-termed intermediate target variables: in Europe today the money supply and the exchange rate often figure as such. The exchange rate in particular plays a major role in open economies, where inflation is due largely to external factors. However, EMU will be a large and relatively closed area, where inflation is determined mainly by internal developments. There is therefore no question of the ECB conducting an active exchange rate policy vis-à-vis the dollar or the yen. That is why I will be discussing only two possible strategies for future monetary policy in Europe: monetary targeting, such as that pursued by the Deutsche Bundesbank for years already, and direct inflation targeting, the strategy applied by the Bank of England.

Monetary targeting is underlain by the notion that in the medium to long term inflation is invariably caused by excessive money growth. In this line of thinking, the central bank can attain its objective of price stability simply by keeping the expansion of the money supply under control. That does not mean to say that the central bank will focus exclusively on monetary growth. Other aggregates containing information about inflationary prospects, especially in the near future, will be monitored as well. These factors act notably as "qualifiers", warning policy-makers against relying excessively on their automatic pilot. Apart from rules, this strategy therefore also provides for a certain measure of flexibility. In this context, I wish to dissociate myself emphatically from those who are wont to accuse my colleagues at the Bundesbank of "rigidity" and "monetary dogmatism". The necessary flexibility is coupled to a high degree of transparency as the central bank explains to the general public how it has

determined its monetary target for the coming period, and goes to great lengths retrospectively to set out the reasons for any deviations from that target. By stressing its responsibility for monetary conditions, the central bank subjects itself to a certain discipline.

For the central bank to be able to live up to this responsibility, the monetary aggregate to be chosen should meet three requirements. First of all, it should be sufficiently controllable. Generally speaking, an increase in the short-term interest rate will eventually lead to a decrease of the money supply. I deliberately say "generally speaking" because monetary policy-makers remember only too well what happened after German unification, when the reverse effect arose at first. Fortunately we now also know that such episodes may be short-lived. Secondly, there must be a sufficiently stable long-term relationship between the demand for money and its determinants, such as prices, income, interest rates and wealth. I will go into this in more detail later on. In the third place, the monetary aggregate needs to have predictive powers as to future inflation. If it does, money growth can be a useful indicator of future inflation.

In the 1980s, monetary targeting was abandoned by several industrialised countries notably on the grounds that national money demand was becoming unstable as a result of financial innovations. It had thus become difficult to assess to what extent changes in monetary growth would be translated into higher prices. The central banks of some of these countries have meanwhile switched to a strategy aimed directly at the attainment of price stability. Their switch was, incidentally, often prompted by the implicit desire of policy-makers to prop up their reputation following years of relatively poor performances in terms of inflation. In 1989, my colleagues from New Zealand were the first to adopt direct inflation targeting. They were followed by Canada, the United Kingdom, Sweden, Finland, Spain and Australia. Although the name suggests otherwise, direct inflation targeting, too, makes use of an intermediate target, viz. *expected* inflation. As expectations are by definition hard to quantify, information variables are employed to forecast future inflation. If the predicted inflation rate deviates from the target, interest rate adjustment is called for.

With a view to forecasting, direct inflation targeting employs, as I have pointed out, several information variables. Such variables are, for instance, changes in wage costs, the exchange rate, commodity prices, equity prices and the money supply. As soon as these indicators point towards rising inflation, the central bank needs to take action. However, the explicit use of a variety of indicators poses a threat to the transparency and credibility of monetary policy, because there is then no immediate way of knowing which information has prompted interest rate decisions. In order to remedy this problem, most countries pursuing inflation targeting have taken to publishing inflation reports setting out the backgrounds to policy measures. Such reports also enable the public to ascertain whether a central bank can be held accountable if the inflation target is not attained. After all, inflation may be caused by factors which are beyond the control of monetary authorities. It is for this reason that most countries cite circumstances under which the inflation target may be ignored or requires adjustment. For example, a number of central banks are not under any obligation to take corrective measures when indirect taxes are raised or when exogenous shocks such as energy price increases arise.

As you can see, the two strategies are actually not as different as their names would have us believe. In practice, elements from both strategies are used, the distinction not always being as clear as it is in theory. The two strategies share the following properties:

- both seek the attainment of the same ultimate goal, viz. price stability;
- both are forward-looking;

- and both make use of an extensive set of indicators to be able to assess whether the course pursued is the right one. In fact the different weights assigned to the money supply form the main distinction between the two strategies.

If the two strategies differ so little in daily practice, how can we compare their pros and cons? To make comparison possible, it has been agreed within the EMI that the ECB will base its choice of monetary strategy on six general criteria, to wit effectiveness, accountability, transparency, medium-term orientation, continuity and consistency with the independence of the ECB. Obviously the criterion of effectiveness is more general in nature than the other five, which can be said to contribute to effectiveness each in their own way. Let us take a brief look at all of them.

Any assessment of monetary targeting has always stressed the criterion of effectiveness. As I pointed out earlier, the effectiveness of this policy is determined by the controllability, the stability and the predictive powers of the monetary aggregate selected. In this context, special attention has always been paid to the stability of money demand. The EMI and other institutions have already extensively studied the stability of money demand for certain groups of EU countries. Though perhaps not quite representative of the situation in Stage Three, the results can be called encouraging so far. It turns out that European money demand functions evince greater stability than comparable relationships for individual countries, Germany included. However, the countries concerned must be sufficiently integrated and converged.

Compared to monetary targeting, direct inflation targeting is harder to assess in terms of effectiveness. This is due to the fact that interest rate measures work through to inflation via all sorts of complicated macro-economic processes, with inflation right at the end of the chain. Direct inflation targeting, too, calls for a sufficient measure of stability of these relationships. Obviously effectiveness is in any case highly dependent on the quality of the inflation forecasts. Moreover, the central bank must be free to react pre-emptively and adequately to any deviations between the desired and the predicted rates of inflation.

In the second place, it must be possible to hold the central bank accountable for the consequences of its policy. It must account for its decisions and explain them to the public. This enhances the confidence which the public at large has in the central bank and contributes to its credibility. As the ECB will be equipped with an adequate range of instruments, it can be held accountable for developments with regard to the money supply. But inflation is determined by more factors, some of which are less amenable to central bank control. That might let the central bank off the hook in the sense that it feels it cannot be considered wholly responsible for any overshooting of a direct inflation target.

Thirdly, policy must be transparent. That means that the public must be informed on both which objectives are being pursued and how decisions have been arrived at. Those in favour of direct inflation targeting like to point out the fact that inflation is a more comprehensible concept than the money supply. On the other hand, transparency is well served when communication with the public at large centres on a single aggregate. In the case of direct inflation targeting, there is the risk that the outside world does not comprehend which indicator has been used this time, a problem which can be solved to some extent by issuing inflation reports.

Fourthly, policy should not be tailored to individual developments, but should have a medium-term orientation, providing some breathing space when the target is not met in the short term. Above all this means that policy should be credible, offering a clear anchor for inflation expectations. Irrespective of the strategy chosen, monetary authorities do not react to every news item which comes their way. Wavering monetary policies only create unrest among both the public and financial market operators.

In the fifth place, monetary policy should be characterised by sufficient continuity while all too frequent policy changes should be avoided. The continuity of monetary policy in Europe would be best served by monetary targeting, the strategy applied for several decades already by the most successful central bank in Europe, viz. the Bundesbank. Moreover, a large proportion of the other core group countries have attuned their exchange rate policies to Germany. One downside of direct inflation targeting as a policy option for the ECB is that little experience has been gained so far with this strategy in periods of heavy inflationary pressure. At the same time it should be kept in mind that the inflation performance of countries which have switched to direct inflation targeting has clearly improved over time.

Finally, the policy strategy selected will need to be consistent with the ECB's independence. By this I mean to say that the strategy chosen must not inspire outsiders to meddle in the discussions on interest rate policy. The Maastricht Treaty is perfectly clear on this point. It would be undesirable if any inflationary differences within the Union were to lead to politicisation of the interest rate policy within the ECB Governing Council. It seems to me that this risk is greater in the case of direct inflation targeting than if monetary targeting were pursued.

I am approaching the end of my address. I have told you which considerations underlie the choice of a monetary policy for the ECB and I have outlined the differences between monetary targeting and direct inflation targeting. The success of either strategy is dependent on largely identical factors. Here a key role is played by vital concepts such as credibility and transparency. It would be recommendable to inform the public regularly and in general terms of the considerations underlying interest rate measures. Furthermore, the ECB will in any case, in the daily implementation of its monetary policy, have to take into account the various indicators which contain information about future price movements. All in all the differences between the two strategies should not be exaggerated.

Nevertheless, I profess that the considerations which I have set out lead me so far to have a certain preference for monetary targeting. The success of the Bundesbank shows that this strategy underpins the competence of the central bank, thus offering an optimum safeguard for its independence. Should you have a different view, then I hope that my address has contributed to a dynamic start-up of the discussion ahead.