Mr. Tietmeyer addresses the topic of the Eurosystem's approach to monetary stability
Address by the President of the Deutsche Bundesbank, Prof. Dr Dr h.c. mult. Hans Tietmeyer to the Swedish Economic Association in Stockholm on April 12, 1999.

I

At the beginning of this year, the euro was launched as a common currency in eleven of the 15 member states of the European Union. As you all know, Germany was one of those countries whereas Sweden, by its own choice, was not. But I am hopeful that this state of affairs - as far as Sweden is concerned - will not persist for too long. As the president of the Deutsche Bundesbank and a member of the Governing Council of the ECB, I have been following the recent debate in your country on the merits and drawbacks of joining the euro area with particular interest. I hope you will therefore allow me to take advantage of your invitation to argue in favour of the Eurosystem's approach to the attainment of lasting price stability which contributes to an environment conducive to lasting growth.
I realise that this will not be an easy task in a country whose central bank is now reaping the fruits of many years of efforts to achieve price stability. The Sveriges Riksbank has recently actually lowered its repo rate slightly below that of the Eurosystem - thus creating a situation which the Eurosystem, of course, could not leave unchanged. Of course, this was not the only reason for our somewhat surprising decision last Thursday. There were other reasons, too. I will come back to them later. In retrospect, in the eyes of the central banks involved, the merging to form a common, larger monetary area went beyond a mere geographical reorientation of monetary policy. It is true that, in the run-up to monetary union (and bolstered by the Maastricht Treaty), there had already been a large measure of convergence in monetary policy thinking in Europe. That primarily affected the ultimate goal of monetary policy, and its institutional framework for achieving that objective. But right up to the start of what was known as stage three of EMU, there remained national differences - some of them substantial - in the practical implementation of policies.

To be sure, the now unified monetary policy of the Eurosystem has recourse in many areas to elements of the earlier national approaches. Even so, in the aggregate it represents a conceptual fresh start. A new system has come into being that calls for adjustments from its members at all levels of monetary policy action. The Bundesbank, too, was and is affected by this change. We have likewise had to adjust to the common approach in a number of respects, and are still doing so today. Against the background of this experience, I should like to single out in this lecture some aspects of the common monetary policy of the Eurosystem which, as it seems to me, are of particular interest to those nations which are preparing for participation in the future.

II

The best and most lasting contribution that monetary policy can make to long-run economic welfare is that of safeguarding price stability. The Statute of the ESCB annexed to the EC Treaty spells out that objective correspondingly clearly. And the assignment of tasks by the Swedish Central Bank Act in the wording in force since the beginning of this year is equally unambiguous. Despite this gratifying correspondence as regards the overall objective and also the large measure of convergence in practical orientation, there are still, if one looks more closely, some differences. Of course they should not be overinterpreted, nor should they be neglected. From the standpoint of monetary policy, with the responsibility for safeguarding the value of money, the question arises, in particular, as to the yardstick by which one's efforts must be measured. Such a yardstick is not provided explicitly in the Maastricht Treaty. After thorough debate, we in the Governing Council of the ECB decided to define an annual increase of less than 2 % in the Harmonised Consumer Price Index (HCPI) as being consistent with price stability in the euro area.

In my view: There are good reasons for such a definition: the choice of a broad index at the consumer-price level takes due account of the addressees of a stability-oriented monetary policy, for ultimately those are consumers. And the quantitative level of the definition by the ECB Governing Council follows from the past experience of the member countries with a long history of stability. By contrast, as far as I know, Sveriges Riksbank has geared its policy hitherto to an inflation target - measured in terms of the rise in the Swedish consumer price index - of an annual rate of 2 %. In addition, the Bank has made it clear that it would tolerate deviations from that target variable in either direction up to a level of 1 percentage point.[1] This was said at least in the Quarterly Review 4/1998 of the Sveriges Riksbank. On average, therefore, price movements in line with the objective of the Swedish Central Bank seem to be compatible with the top edge of the quantitative definition of price stability under the Eurosystem. Even so, on the way to that average, the Swedish target definition tolerates inflation rates exceeding the Eurosystem's definition of price stability.[2] Much the same also applies to the Bank of England, which is pursuing a year-on-year inflation target of 2.5 %, measured in terms of the RPIX (retail price index excluding mortgage interest payments).

That is all of what I say on the small, but not negligible differences in the context of target definition. In the run-up to stage three of European economic and monetary union, however, more heat was generated by the debate on which monetary policy strategy should be used to reach the objective than by the precise definition of what is deemed to be compatible with price stability. In the upshot, the Eurosystem today is relying on two pillars for attaining its quantitative idea of price stability: on the one hand, on a comparison of monetary growth with a reference value for the movement of the broad money stock M3; and, on the other, on a broadly-based analysis of the prospects for future price movements in the euro area. But, unlike the practice of the Swedish and UK central banks, both of which are pursuing a strategic approach of direct “inflation targeting”, the Eurosystem's policy approach - at least till now - has not culminated in the publication of an inflation forecast. And, in my view, there are very good reasons for not doing that! I shall revert to this point later on. In my opinion, all this implies that the Eurosystem has opted for a strategy that reflects with all due clarity the particular responsibility of monetary policy for medium-term price movements. It thus does justice to the assignment of roles prescribed by the Maastricht Treaty.

Well, answering the question as to the medium-term orientation of monetary policy is one thing. But the question as to the shorter-term orientation of monetary policy within the business cycle is quite a different matter. That debate is currently undergoing a renaissance in Europe. Given the new monetary policy regime, which still has to be ”run in”, and the differing former traditions of monetary policy orientation in the individual countries, that comes as no surprise. Many countries in the euro area were hardly affected by that question for a long time, since they were primarily pursuing a policy of exchange-rate orientation. The Eurosystem, however, cannot and will not do that. It has to follow its own internal orientation! And, against the background of the clouded prospects for economic activity in the euro area as a whole, calls for recourse to monetary assistance measures, which are comparatively easy to deploy, have become more vociferous of late.

I should first of all like to emphasise with all due clarity that the assignment of roles under the Maastricht Treaty does not provide for ex ante coordination of different economic policy areas in the sense of coordinated demand management. Incidentally, such coordination is neither desirable nor necessary if every policy area discharges its own responsibility. Complying with our responsibility for price stability, we in the Governing Council of the ECB last Thursday decided to lower our interest rate for the main refinancing operations by 50 basis points. Based on both pillars of our strategy, that decision was taken in a forward-looking perspective. We judged that current trends in monetary aggregates do not signal future inflationary pressures, and that - assessing all other relevant

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[1] Cf., for instance, Lars Heikensten and Anders Vredin, Inflation targeting and Swedish monetary policy - experience and problems, in: Sveriges Riksbank (Ed.), Quarterly Review, 4/1998, pages 5-33, especially page 5.
[2] A direct comparison of the differing definitions of inflation rates deemed to be consistent with price stability presupposes that the underlying (different) indices do not diverge substantially. In point of fact, the HCPI encompasses about 80 % of the Swedish consumer price index. Cf. Sveriges Riksbank, Inflation Report 4/1998, page 9, footnote 1 and page 51, chart 1 in the appendix, for a comparison of the movements of the two indices.

information - the price movements most probably will keep in line with our definition of price stability. Thursday's decision keeps our monetary policy on a longer-term stability-oriented course.

The decision and its underlying rationale demonstrate continuity and do not in any way indicate a paradigm change to short term demand management. By doing so, the decision contributes to creating an economic environment in which the considerable growth potential of the Euro area can be exploited. Those responsible for other policy areas are urged now even more to take the necessary steps to improve longer-term growth prospects for the euro area. A cut in the central bank's rates cannot be a substitute for convincing structural reforms in the economies. That should always be kept in mind in discussions on the stabilisation potential of monetary policy. If monetary policy tries to meet other objectives, the risk of missing the main objective is great. Specifically, the Eurosystem is sometimes accused by critics of squandering opportunities because of the type of final goal definition selected.

That relates, to begin with, to the alleged asymmetry of statistical price rises that are consistent with price stability in the view of the Eurosystem. But the assumption of asymmetry is based primarily on a misinterpretation of the quantitative definition. Thus, it is quite clear from the formulation chosen that, in the view of the monetary policy makers in the euro area, both a deflation in the sense of a sustained decline in the price level and a rate of monetary erosion of 2 % and more are deemed to be harmful. Hence undue importance should not be attached to the fact that the ECB has refrained from formally defining a floor for the objective of price stability. That is due not least to uncertainties with regard to the measurement-error problem posed by the Harmonised Consumer Price Index.
But the criticism sometimes also applies to the formulation of the stability objective in the shape of a target corridor, rather than a possible orientation towards a single-figure target. If the criticism were warranted in this respect, it would, incidentally, also apply to the Swedish central bank, which - unlike the practice of inflation targeting in, say, the UK - has likewise formulated its target variable in the shape of a corridor.

The starting point of this corridor debate is therefore the fact that - at least in theory - a central bank that gears its policy to a single-figure target, rather than a target corridor for price movements, is likely to take monetary countermeasures earlier if changes occur in the price outlook; hence, it tends to be more activist. To the extent that observed variations in inflation were due to similar cyclical fluctuations in macroeconomic activity around its trend rate, the more activist policy would, according to the critics, achieve two things at once: the stabilisation of the variations in inflation and the stabilisation of output.

But, in response to that assertion, it must be said that not every change in price movements is due to cyclical fluctuations in demand. If, however, the cause is to be sought in changes on the supply side (e.g. in advances in productivity) monetary countermeasures with the aim of bringing the inflation rate back on to its target path as quickly as possible may accomplish just the opposite of what is wanted: For example, such a monetary policy would run the risk of stimulating macroeconomic growth to an extent that is incompatible with the long-term production potential of the economy. That stimulus would then have to be countered again by monetary policy action. Hence an unduly activist policy would tend to cause volatility by itself.

Moreover, differing time-lags between taking the decision and its coming into effect might well engender unwelcome cyclical effects. Excessively volatile monetary policy likewise hampers long-term financing in the markets, and thus exacerbates the risk posed to real investment on the financing side. The criticism of the Eurosystem expressed in this connection also pays too little heed to the role played by the quantitative definition of price stability within the chosen strategy. It is true that, if an approach based on inflation targeting is pursued, it is primarily the forecast deviation of the inflation rate from its target rate that serves as the guideline for the deployment of policy instruments. Hence, under this approach, the specific definition of the stability objective is indeed of crucial importance for monetary policy in the short run. That, however, is not the approach adopted by the Eurosystem!

Instead, the strategy of the Eurosystem opens up other options for the appropriate consideration of the interaction between the deployment of monetary policy instruments and macroeconomic fluctuations.

At this juncture, I only wish to allude briefly to the fact that the reference value for monetary growth was derived with due consideration of the prospective movement of production potential. To this extent, the Eurosystem's strategy already includes to some extent a built-in stabiliser within the business cycle. Anyway, it seems to me to be questionable how far monetary countermeasures only based on inflation forecasts (which are by their very nature always uncertain) can satisfy theoretical requirements. After all, they neglect the uncertainty ruling in practice about future price movements.
The degree to which such uncertainty exists over forecasting horizons that are relevant to monetary policy is also demonstrated for Sweden, after all, by the inflation forecasts of Sveriges Riksbank.[3] For instance, the width of the corridor in which the future inflation rate will lie with a probability of 50 % for a one-year time horizon is already roughly one percentage point. For a two-year perspective it actually doubles. If this degree of uncertainty of the inflation forecast is compared with the target corridor of the Eurosystem's definition of price stability, the criticism levelled at the corridor concept appears at most to be relevant in theory.

III

A major prerequisite of the Eurosystem being successful in discharging its stability mandate without incurring unnecessary real economic costs lies in it rapidly acquiring the credibility that it can do just that. Needless to say, such credibility is particularly essential for a new institution like the ECB. In this context, it has become fashionable to draw attention to the role played in this by the transparency of monetary policy. Disinclined though I am to question this correlation between credibility and transparency (quite the contrary!), I find myself unable fully to comprehend the criticism - mainly coming from outside the euro area.

First and foremost, the concept of transparency designates quite generally the disclosure of information that is relevant to the conduct of monetary policy. Such information may relate to utterly different areas of central bank policy: - to the basic institutional framework under which it operates, - to its precise objectives, - to its strategy and - to the instruments at its disposal. In addition, the detailed and up-to-date notification of the general public about monetary policy decisions and the reasons behind them must certainly also be included.

There is general agreement on the advantages of monetary policy transparency: firstly, as I mentioned before, transparency is able to enhance the effectiveness of monetary policy. Moreover, the understanding of monetary policy is facilitated among the general public, always provided it is successful; the credibility of monetary policy can be fostered more readily in this way. This is accompanied by the anchoring of the public's inflation expectations at the level envisaged by the central bank. That minimises friction between monetary policy and other economic policy areas.

Secondly, the transparency of monetary policy plays a major supporting role in connection with a central bank's accountability. That applies particularly to central banks which, in the light of their legal status, can operate independently of other policy areas. The disclosure of their objectives and of the reasons for their decisions constitutes the preconditions for an effective "monitoring" of central bank policy - of its intentions and its efficiency alike - by the public at large. It follows from this that notably the Eurosystem (as a new monetary policy institution, which, moreover, enjoys a status of substantial independence in the discharge of its stability policy mandate) should endeavour to adopt a policy approach which is as transparent as possible. Frankly speaking, I cannot see what more the Eurosystem could do in order to accomplish that. In the first place, its objective is defined with all due unambiguity in the Treaty of Maastricht. And with respect to the chosen monetary policy strategy, and

[3] Cf. Sveriges Riksbank, Inflation Report 4/1998, page 42f.

also to the range of instruments at its disposal, the Eurosystem has meanwhile kept the general public comprehensively informed.

At the centre of the current debate on the transparency of monetary policy in the euro area is the issue of how precisely, and especially in which form, the public should be notified of details of the internal decision-making process and the decision-making rationale. Specifically, the question is, inter alia: to what extent should information-disseminating instruments which have been used by other central banks likewise be deployed in the Eurosystem? Besides the above-mentioned publication of explicit inflation forecasts, frequent reference is also made in this connection to the publication of the minutes of ECB Governing Council meetings. I would like to say the following: Additional information presented to the general public actually enhances the transparency of monetary policy only if it can help to make the monetary policy decision-making process clearer than it was before.

Specifically with reference to the publication of a model-based inflation forecast by the Eurosystem, that may be doubted. For one thing, the Eurosystem is, after all, not pursuing a strategy of inflation targeting, under which the precise forecast path of future inflation (supplemented, if need be, by information on the degree of uncertainty of the forecast) plays the key role in the decision-making process. It is this that distinguishes monetary policy in the euro area from the policy pursued by those central banks which publish explicit inflation forecasts and gear their policies to them. The Eurosystem is geared to two pillars: the reference value for monetary growth and a broadly-based analysis of future price movements. On the publication of an official inflation forecast, that forecast might assume, in the eyes of the general public, an importance which it does not merit under the strategy adopted.

To this extent, such a forecast could actually be misleading. In any case, it is legitimate to ask whether it is prudent for a policy-maker to publish a precise forecast. On the one hand, there is always the risk of a self-fulfilling prophecy, and on the other, a problematic yardstick for his credibility may be erected without him being fully in control of its realisation himself. For another thing, in view of the change in the monetary policy regime, inflation forecasts for the euro area are currently subject to even more uncertainty than usual. The need for frequent revisions also militates against any overly prominent role for that communication tool. Similarly, the debate on a publication of the minutes of the meetings of the ECB Governing Council reflects in my view not so much the question of principle concerning the enhancement of transparency as, rather, the differing approaches towards achieving that.

In the “philosophy” of the Eurosystem, the Governing Council of the ECB, as a collective body, is committed to displaying accountability vis-à-vis the general public. National considerations should not be of any significance in the decisions taken by that supranationally operating body. The publication of the standpoints adopted or of the final votes cast by individual Council members, which, for them, always involves the risk of being exposed to political pressure in their respective countries, tends to be disadvantageous here. Quite apart from the fact that publicising differences of opinion is likely to do more harm than good to the stabilisation of expectations.

By contrast, it appears to me that the chosen route of detailed notification of the general public by the ECB President immediately after the meetings of the Governing Council promises to be more successful. Those statements by the President discussed and agreed by the Council members reflect the prevailing assessment of the Governing Council and set forth in some detail the conclusions which it considers necessary to divulge. That makes the current state of debate transparent to an extent such as does not obtain in any other central bank. At any rate, a statement by the ECB President immediately after the decision was taken and in front of the critical journalists seems to meet the need of the public and the markets for explanation and transparency more efficiently than a mere reference to a later publication of minutes does. To make my views on this point abundantly clear: I consider a maximum of monetary policy transparency to be desirable. However, I am not convinced that that is necessarily synonymous with the publication of very specific information on minutes.

IV

Transparency and information are indispensable, not only to the efficiency of monetary policy but also to the avoidance of crises in the financial system. Hence the fostering of appropriate standards of transparency and disclosure for all market players formed an integral part of the proposals I submitted last February with a view to improving international financial architecture. Incidentally, the Financial Stability Forum which I suggested, and which was endorsed by the G-7 ministers and governors, will convene in Washington on the day after tomorrow under my chairmanship for its constituent meeting. However, these proposals and ideas must be sharply distinguished from calls for the central bank to specify preventively how it intends to respond in the event of a crisis besetting the financial system.

The ECB is sometimes criticised for having not clarified its role as a lender of last resort in a crisis situation. In that connection, transparency may be positively harmful. In this context, two concepts are of key significance: “lender of last resort” and “moral hazard”. It is its monopoly position in the creation of central bank money as a definitive payment medium that enables a central bank to cope with a system-imperilling liquidity shortage in the financial sector. If the central bank supplies liquidity for that purpose - i.e. acts as the lender of last resort - that may have undesirable repercussions. Just possibly, more liquidity will be created than is consistent with the objective of price stability.

Besides this conflict with monetary policy objectives, the role of being the lender of last resort may also give rise to serious adverse developments in the banking sector: if individual banks believe that they can rely on the central bank “bailing them out” in the event of liquidity problems, that encourages lax risk management or even deliberately over-risky behaviour - that is to say, the above-mentioned “moral hazard”. Transparency with respect to the lender-of-last-resort function would ultimately amount, for those players who regard themselves as being safeguarded thereby, to nothing but a blank cheque on the central bank. This is why, as long ago as 1974, following the Herstatt crisis, the G-10 central bank governors expressly reaffirmed the risks associated with any foreseeable action as lenders of last resort, and rejected ex ante regulations. I regard that statement by the governors as being as topical as ever. Correspondingly, central banks, if I may borrow a phrase from my colleague Eddie George of the Bank of England, consistently practice what he called “constructive ambiguity”: a lower degree of transparency fosters the careful valuation of risks and thus results in a higher degree of financial market stability.

Furthermore, the Deutsche Bundesbank does not even have an express mandate to safeguard financial market stability. Even less does that apply to any lender-of-last-resort function, however that may be defined. Although it is involved in banking supervision, it is not responsible for the decisions itself, either. In other European countries, most central banks are more directly involved in financial market supervision and banking supervision.

Historical-induced differences in the “supervision culture” likewise affect the attitude towards a lender-of-last-resort function. But in the final analysis this, too, is another variant of “constructive ambiguity”. Incidentally, the Maastricht Treaty deliberately left banking supervision - at least, for the time being - in the hands of the national authorities. However, that situation can be changed (pursuant to article 105 paragraph 6) by a unanimous decision of the Council of Ministers. Yet the ESCB is required to contribute to the smooth execution of national supervision over credit institutions, and to the stability of the financial system. The approach adopted in Germany to the prevention of crises has been distinctly successful so far. It has included - besides the stability-oriented stance of monetary policy, which has helped, for instance, to avoid exaggerations in asset prices (“asset-price inflation”), the primarily long-term oriented financial market culture and efficient banking supervision - above all the mechanisms of internal control and peer-group pressure in the banking industry. I may mention as examples the very far-reaching deposit guarantee scheme in Germany and the joint audit associations of the various large categories of banks.

Correspondingly, in the event of a crisis, all possible private sector solutions are normally sounded out first, just as in most other countries. The internal control mechanisms of the banking industry in Germany, in respect of liquidity assistance in crisis situations, led to the establishment of what is known as the Liquidity Consortium Bank (Liko Bank) in 1974. The various categories of the banking industry and the Deutsche Bundesbank hold participating interests in that bank. In a crisis, the Liko Bank can grant short-term liquidity assistance to institutions which are considered to be solvent and have run into liquidity difficulties through no fault of their own. The Liko Bank is financed through capital and reserves which can be increased by virtue of an obligation on the part of shareholders to make further contributions and by bills of exchange whose standing is assured by corresponding signatures of other banks. Such securities can be used as blue-chip collateral to obtain funds from the Bundesbank. Hence the Liko Bank acts, so to speak, as a lender of next-to-last resort. It ensures a kind of "institutional transparency" as far as the management of liquidity crises is concerned, without impinging on the Bundesbank direct. By this means, and thanks to the involvement of the commercial banks, the moral hazard risk is minimised. This appears to me to be a successful model that might also be applied in EMU and we have to discuss this.

However, the existing differences in the approaches towards containing systemic risk in the financial sector in Europe are - it may be emphasised once again - more differences of degree than differences of a fundamental nature. Hence the ability of the Eurosystem to act in the (unlikely) event of a crisis imperilling the system is assured. There are in the meantime clear agreements to this effect within the Eurosystem. Under these agreements, should the need actually arise, the diverse national arrangements would be applied first.

But it goes without saying that the Eurosystem would be involved as well if liquidity effects on a scale relevant to monetary policy were felt. In the shape of the ECB Governing Council and Executive Board, the Eurosystem has decision-making bodies which - if need be - can take the requisite decisions swiftly. More cannot be said and more should not be said. The moral hazard risk forbids that.

V

Viewed as a whole, the approach of the Eurosystem appears to me to be well suited to coping with the manifold challenges faced by a common monetary policy. But the real challenges lie outside the monetary policy sphere and they have to be addressed convincingly by other policy areas. We all hope that the euro will be a success story and that the so-called pre-in countries will join the euro as early as possible. In the light of the desirable early enlargement of the number of participants, at the points where there are still differences between the Eurosystem and the "pre-ins" in the monetary policy field, a further "convergence process" would undoubtedly facilitate the entry into monetary union. Furthermore, given the exchange-rate criterion set by the Maastricht Treaty, the question likewise arises for Sweden and the UK as to accession to the EMS II system. But I am deliberately refraining from going into that tonight.

At any rate, I should welcome it if the EU country Sweden were soon to take the final step into European monetary union. Without a country of such rich tradition and strong economic performance as Sweden undoubtedly is, European monetary union remains incomplete. That is why we were all delighted that Sweden ratified the Maastricht Treaty. Myself, I am quite convinced that one day it will take advantage of the options the Treaty envisages, meet all the convergence requirements and join the monetary union. But the decision rests, of course, with the Swedes themselves. All I can say is: you are warmly welcome.