THE ECB AND THE EURO
MONETARY POLICY FOR A NEW CURRENCY

By

Professor Otmar Issing

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SPEECH BY PROFESSOR OTMAR ISSING

MEMBER OF THE EXECUTIVE BOARD

OF THE EUROPEAN CENTRAL BANK

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When designing its monetary policy strategy, the ECB has decided not to follow the examples of other prominent central banks in the world. One of the reasons has to do with the uniqueness of the ECB's position – having to start taking monetary policy decisions for the euro area without any previous experience of the structural features of the area as a whole, and of its reaction to the single monetary policy. The transition to the EMU and the unique nature of the euro, a single currency shared by many sovereign nations, have been the distinctive features of the single monetary policy since the very beginning. The design and implementation of monetary policy for the area as a whole has always had to confront itself with the specific and exceptional uncertainties arising from the creation of the monetary union.

By its nature, the monetary union epitomises a policy regime shift. Following the shift, significant changes were to be expected in wage and price behaviour, in the portfolio allocation of savings, in the financing decisions of firms, in the role of financial intermediaries. We now have clear evidence of ongoing transformations in the banking sector, for example. Consequently, it has been impossible for the ECB to rely blindly on past experiences.

Quite separately from the uncertainties related to the policy regime shift, the creation of the euro area introduced a discontinuity in the available statistical information. Long time series data are still not available for the euro area and must therefore be replaced by synthetic aggregates. This raises methodological and conceptual problems. Furthermore the set of statistics available for the euro area is more restricted than what is normally available to a central bank of an industrialised country, although the Eurosystem, Eurostat and the statistical institutions of the member countries are actively engaged in making the necessary statistical improvements in the shortest possible time.

In an ideal world, given the difficulties related to the creation of the monetary union, we could have waited a few years and only started taking policy decisions after the resolution of uncertainty. In the real world, this option was unavailable. The ECB has had to design its monetary policy strategy in such a way that it would represent a useful framework both for "normal times" and for the exceptional initial years of the single currency.

It should be no surprise that the resulting strategy is different from those adopted by other central banks.

The main challenge: the quest for credibility

A fundamental and immediate objective of the strategy was to establish quickly the credibility of the ECB in an environment of heightened uncertainty. Credibility reduces the likelihood that temporary deviations from price stability are interpreted as signals of either a myopic attitude of the central bank, or a mistaken attempt to pursue unattainable objectives, attitudes that have both been shown to cause an inflationary bias. Furthermore, high credibility helps to enhance the efficiency of monetary policy, since it implies that private agents' expectations change consistently with planned central bank actions.

In our quest for credibility, however, a fundamental challenge derived from the ECB's lack of a track record, a shortcoming intrinsic to any new institution in charge of monetary policy for a newly created economic area. To illustrate the implications of this problem, let me quote from Alan Blinder's survey on credibility, conducted amongst a large number of central bankers and academic economists. "When it comes to appraising methods of building or creating credibility – Blinder concludes on p. 21 – the views of central bankers and economists are closely aligned. Establishing a history of living up to its word is ranked first …".[1]

Nevertheless, while lacking a track record, the ECB was not in the position of having to start from scratch in building its credibility. Owing to the efforts of the European legislator, the Council had the strong support of an excellent institutional setting.

First and foremost, according to an explicit provision in the Treaties of the European Union, the new central bank was able to rely on its clear institutional independence from political pressures. Blinder's survey suggests that, whereby the track record of living up to one's words is most useful in order to build credibility, "central bank independence is ranked second" (p. 21).

Second, the ECB's institutional setting has the advantage of including a mandate which explicitly emphasises the maintenance of price stability as the *primary* objective to be pursued by the new institution. The assignment of monetary policy to the ultimate goal of price stability is consistent with the widely held view that price stability is a necessary condition for an economy to enjoy sustainable growth. In this sense, the European legislator acknowledged that it is only when price stability prevails that the relative price signals on the basis of which investors, businesses and the public at large make decisions do not give misleading information. By maintaining price stability, a central bank contributes to minimise distortions in the allocation of resources, which is the best contribution it can provide to foster growth at the economy's productive potential.

[1] Quotations and page numbers are based on: Blinder, A. (1999), "Central Bank Credibility: Why Do We Care? How Do We Build It?", NBER Working Paper No. 7161, June.

A third source of strength in the quest for credibility derived from the legacy of participating National Central Banks and from the convergence process which took place during Stage 2 of the European Monetary Union. The convergence criteria had in fact ensured that, by the end of 1998, virtually all countries participating in the euro were experiencing inflation rates consistent with price stability, as acknowledged by the Governing Council in its October 1998 Press release. Conditions consistent with price stability were obviously favourable for a central bank entrusted with a strong price stability mandate.

While providing help, however, independence, a strong mandate and favourable initial conditions could not be expected by themselves to deliver credibility. If one searches for guidance in the academic literature, one finds the recommendation that a central bank should also adopt, and commit to, a simple monetary policy rule: a rule, more precisely, prescribing exactly, and according to a simple mathematical relationship, how policy interest rates should be steered in response to developments in a restricted number of economic variables. It is obvious why such an announcement would be conducive to credibility. A simple rule is easy to understand and its adoption can be immediately verified by economic agents. It therefore leaves no margins for interpretation for the naïve, or deceitful, policy maker.

Yet, would a simple rule truly be credible in the real world? It goes without saying that it would frequently be confronted with contingencies not foreseen at the moment of its design. We have a very recent, unfortunate, historical example of such contingencies in the events of September 11 in the United States. When these contingencies occur, it becomes beneficial for monetary policy to deviate from the simple rule. Even if the central bank unrelentingly stuck to the rule, the possibility of policy decisions which differ from those consistent with the rule would certainly be discounted in private sector's expectations. This would end up weakening the credibility of the simple rule, which also represents its key positive feature.

In addition, the choice of the exact simple rule would in practice be very problematic. Even rules sometimes referred to with a unique name in the academic literature often yield significantly different policy implications in response to, for example, small changes in parameter values. While differences of the order of 50, or 100 basis points are often considered as negligible in academic studies, they are large in a world where the policy debate often focuses on whether to raise policy rates by 25 basis points, or to simply leave them unchanged.

Tying the ECB's hands to an arbitrarily selected simple rule would therefore have been inappropriate. Nevertheless, the literature on credibility through commitment has taught us an important lesson. This concerns the importance of providing the public with an *ex ante* description of the general characteristics of the central bank's reaction function or, in practice, of the monetary policy strategy used to structure information and help the decision-making process. In October 1998, almost three months before the start of the single monetary policy, these considerations led to the announcement of the strategy soon be adopted by the European Central Bank: the stability-oriented strategy.

The ECB's approach: the stability-oriented strategy

The first component of the strategy was a clear definition of what exactly should be interpreted as price stability in the euro area. In October 1998, the Governing Council clarified that, in accordance with previous analogous orientations of European political bodies, inflation above 2% would be considered inconsistent with price stability in the euro area. At the same time, we expressed clearly that we are concerned about both inflation and deflation, thereby signalling that the definition of price stability is symmetric.

The definition of price stability represents a signal of the commitment of the ECB to its statutory objectives. As it makes it possible for any interested party to immediately assess whether the euro area economy is, or is not, at price stability, it represents a contribution to the accountability of the new central bank. Moreover, it contributes to provide an anchor to medium term inflation expectations.

Besides providing a numerical definition of the price stability objective, however, it was important to also define, and convey to the public, the general features of the monetary policy which would guide the decision making process of the ECB as of January 1999.

At critical junctures such as this, one always looks back at past experience and at the stratified wisdom of the existing literature. At the ECB, we asked ourselves the old question on what monetary policy can and cannot do. A recent book, *Monetary Policy in the Euro Area*, written jointly by myself and three members of the staff of the European Central Bank and published by Cambridge University Press, explores this issue at length.

In a nutshell, theory and empirical evidence agree on a strong result: a change in the stock of money ultimately has a one-to-one effect on prices and no effect on real economic variables. This neutrality result emerges from virtually all models of monetary economies, and is supported by a large number of empirical analyses.

Against this background, there is little we know about the effects of monetary policy in the short run. A vast number of studies, mostly based on vector autoregressions, have only started to unveil broad features of the average time lag at which monetary policy produces effects on a number of economic variables. Their results do not contradict the old characterisation according to which transmission lags are "long and variable". There is also very little we know on the exact functioning of monetary economies, i.e. on the economic model which provides the most appropriate characterisation of the world in policy simulations.

Taking these findings into account, it becomes clear that the most important property of a monetary policy strategy – especially one to be deployed at a time of exceptionally high uncertainty as to the functioning of the economy – must be its robustness to model uncertainty. Such a strategy should be designed so as to be able to deliver good results under a variety of different circumstances, rather than be based on a specific view of the functioning of the world. Against the background of economists' and central bankers' imperfect understanding of the economy, a diversified approach to the interpretation of economic conditions reduces the risk of large policy errors.

In the midst of the pervasive uncertainty faced by the ECB, the aforementioned relationship between money and prices stood out as the ultimately robust theoretical and empirical result which the single monetary policy could safely rely on. In the limiting case of complete ignorance of a central bank on the functioning of its economy, the relationship between money and prices would represent the only useful policy indicator. From this standpoint, the "special" role of money, which is part of the first pillar of the stability-oriented strategy, follows immediately as an obvious corollary.

It was also immediately clear, however, that the money-price relationship could not be blindly used to guide monetary policy decisions at high frequencies. More generally, no central bank can afford to disregard information. That is, no central bank can avoid the need to continually assess the state and the operation of the economy using a multitude of indicators and information variables. Policy decisions are ultimately based on the comprehensive assessment of recent developments in all these indicators and variables. The second pillar of the stability-oriented strategy is there to emphasise that the ECB takes into account all information which is relevant for the assessment of future prospects for price stability.

The other features of the stability-oriented strategy are common to the approach of many successful central banks. There is a fairly widespread consensus that a central bank should formulate its monetary policy in a forward-looking way, with a view to taking decisions in a pre-emptive fashion. It is essential to eradicate inflation before an inflationary psychology becomes entrenched in peoples' attitudes and behaviour. At the same time, it is important to adopt a gradualist and measured response to some types of unforeseen economic disturbances, in order to avoid creating additional and unnecessary volatility in output and interest rates.

For these reasons, the monetary policy strategy of the ECB explicitly adopts a medium term orientation. The medium term horizon also acknowledges the existence of short term volatility in prices, possibly arising from a variety of sources, which cannot be controlled by monetary policy.

Main characteristics of the operational framework

The set of instruments, procedures and practices used to implement monetary policy decisions constitutes the "operational framework" of a central bank. Based on the recent international experience of central banking practices, the operational framework of the single monetary policy was designed to satisfy three broad requirements: first, to be consistent with the strategy, and in particular with the efficient pursuit of the statutory objective; second, to ensure an effective communication between the central bank and the market, i.e. convey a clear signal of the current monetary policy stance; third, to be in line with the principles of a market economy, in order to favour the efficient allocation of financial resources. These three criteria – *goal efficiency*, *signalling capability*, *market compatibility* – have in fact guided the evolution of the operational framework of all main European central banks in recent years.

The selected "European model" is characterised by its reliance on self-regulating market mechanisms and by a limited presence of the central bank in the open market. A "corridor", defined by two interest rates predetermined by the central bank, contains fluctuations of short term money market rates within a band. Short-term operations, used to provide the bulk of refinancing and to regulate the supply of central bank money, are predominantly carried out against high-quality collateral. Reserve requirements are used to smooth daily fluctuations of the overnight interbank rate through an averaging mechanism. Reserve deposits are remunerated at the interest rate applicable to the main refinancing operations.

With hindsight, the operational framework worked remarkably well right from the beginning. The experience of the early months after the introduction of the euro provides evidence that the framework is sufficiently "market-friendly". Several indicators suggest that agents, particularly commercial banks, adapted relatively quickly to the new operating environment, notwithstanding the sizeable portfolio adjustments and cross-border payments, which took place at the start of Stage Three both within the euro area and with the rest of the world.

Accountability and transparency

A good approach to monetary policy must not only ensure that policy makers receive all the information necessary to take appropriate decisions in a structured and coherent form. It must also constitute a clear framework for communication with financial markets and the general public, so as to allow the central bank to explain the economic rationale at the base of its monetary policy decisions in a consistent manner over time. Indeed, besides representing a coherent framework to structure information and the decision-making process *internally*, the monetary policy strategy is also the framework used to explain monetary policy decisions *externally*.

The latter requirement – the need to ensure transparency of the policy making process – is of no lesser importance than the first – the need to process efficiently all the information and knowledge relevant for appropriate policy decisions. In a democratic society, a high degree of transparency in monetary policy making reinforces the legitimacy of the central bank and consolidates the public support for its price stability mandate. Furthermore, transparency imposes discipline on policy makers and is a means to ensure a general understanding of the monetary policy strategy. In turn, this may enhance the credibility, and thereby the effectiveness, of monetary policy, hence facilitating the central bank's effort to attain its statutory objectives.

While it is easy to agree on this general principle – transparency is an important element of monetary policy – its application to the modern central banking practice is far from straightforward. Transparency is not simply a question of making the maximum amount of information available, but requires clarity to enhance the public's understanding of monetary policy. Complete transparency on the underlying information set, as well as the thinking and ulterior motives behind central bankers' decisions, is practically impossible to achieve. As also pointed out by John Vickers, "there is surely information relevant for policy-making that is simply incapable of being put in the public domain. In that case, and with the best will in the world, optimal monetary policy cannot be absolutely transparent, nor totally boring".

The reality of monetary policy decision making is extremely complex. At each point in time, the economy sends apparently conflicting signals, seemingly validating different models or views of the world depending on occasions and circumstances. These signals are inevitably incoherent with any one theoretical framework. The degree of complexity of the decision making process is intensified for those central banks, prevalent in large monetary areas, governed by collegial bodies.

Describing the best collective assessment emerging from each meeting of the Governing Council in an honest, clear and synthetic manner is a daunting problem which by its very nature lacks a straightforward solution. It is only natural that different approaches, each of which depends on a myriad of circumstances and considerations, may be explored by different central banks, in spite of the common aim to achieve transparency of their decision making process.

The effort to achieve maximum transparency can only be made in the context of a certain model of communication through which information is interpreted and summarised for the benefit of the public. The "words" used for the purpose of external communication must therefore correspond to the "deeds", i.e. they must clearly convey the *actual* internal policy process.

Because the ECB has been assigned a clear and narrow task, *accountability* should be based primarily, if not exclusively, on the central bank's observable record in fulfilling its mandate. As mandated by the EU Treaties, accountability of the ECB is related primarily to the maintenance of price stability in the euro area. The quantitative definition of price stability provided by the Governing Council increases the accountability of the ECB beyond the already exacting reporting requirements under the EU Treaties. This reflects the conviction that in a democratic society accountability is the reverse side of the coin of central bank independence.

In terms of transparency, the ECB has tailored its communication policy to the particular challenges posed by a large and complex monetary area. The euro area now consists of twelve different sovereign nations, each with its own distinct monetary history and heritage. For this reason, the communication policy of the ECB has attributed an important role to the press conferences directly following the first Governing Council meeting of each month. At the centre of the ECB communication policy, however, stands the Monthly Bulletin, which intends to provide the general public and financial markets with a more thorough assessment of the economic environment.

In December 2000, at the end of a period of development and testing, the ECB also started to publish its macroeconomic projections. The publication of the staff projections reflects the desire to share with the public an important piece of information available to the Governing Council. It can only represent an effective contribution to transparency, however, if the role that projections play in the policy process is clearly understood.

Projections solely provide a counterfactual scenario, based on the specialised assumption of unchanged interest rates and produced with the help of a variety of inputs, including the technical judgement of staff experts both at the ECB and at the NCBs. Projections are therefore only one of the information inputs in the decision-making process of the Governing Council. The final and fully informed assessment of the outlook for price developments and the risks to price stability, which is at the base of monetary policy decisions, remains the preserve of the Governing Council. It is exactly to clarify this limited role that the ECB has preferred to use the term “projections” to the more commonly used “forecasts.”

The uncertainty surrounding the projections is portrayed through the use of ranges rather than point values. It was decided to base the width of the ranges on the average absolute errors made in previous NCB and Eurosystem projections. Since projections are not strictly model based, it should also be emphasised that ranges do not provide an accurate representation of the true degree of uncertainty surrounding the assessment of future macroeconomic outcomes. The use of ranges is mainly an attempt to convey the conjectural nature of many assumptions and judgements implicit in the projection. Along the same lines, the absence of a mean, or modal, value should avert the risk of portraying an unrealistic picture of our knowledge of those uncertainties.

The **single** *monetary policy in action*

It is still too early to be able to provide a complete assessment of the performance of the ECB so far. Monetary policy transmission lags imply that we are only just starting to observe the effects produced by the decisions which have been taken since the beginning of EMU. However, we already have evidence that makes us look into the future with a reasonable degree of optimism.

The first piece of evidence concerns monetary policy credibility. Has the stability-oriented strategy proved successful in this crucial respect? In order to answer this question appropriately, it is useful to analyse in some detail euro area macroeconomic developments during the past three years.

A simple inspection of inflationary dynamics up to May 2001 would in fact appear to show reasons for concern. In the context of a prolonged decline in the external value of the euro, a marked oil price shock and a sharp acceleration in food price dynamics – due to animal diseases – had led to an increase in HICP inflation up to a peak of 3.4 percent. In June 2001, when the May inflation figure was released, an observer could have worryingly noted an almost steady increase in the euro area inflation rate ever since the start of the single monetary policy.

What sharper test of monetary policy credibility could one bestow on a new central bank? From this viewpoint, June 2001 was a very important cornerstone in the initial life of the ECB. It represented a crucial occasion in which to assess whether the citizens of the euro area had, after two and a half years, digested the broad features of the stability oriented strategy and its implementation, i.e. understood the nature of the commitment of the new central bank.

The credibility assessment can be made on the basis of long term inflationary expectations. Were these consistent with the price stability objective, or were they discounting an inflationary bias as a result of the recent inflation increases? An objective measure of such inflationary expectations can be extracted from the yields on long-term bonds, which are determined by the impartial jury of financial markets. The conclusion is that the ECB immediately earned, and consistently maintained over time, a considerable level of credibility. Despite the aforementioned inflationary developments, long-term interest rates in the euro area have constantly remained consistent with the prospects of a prolonged period of price stability. Even in June 2001, when we learnt that inflation had jumped to 3.4 percent the previous month, 10-year inflationary expectations extracted from index-linked bonds remained anchored at levels safely below 2 percent. Quite remarkable, isn't it?

More recent developments have done nothing but suggest that financial markets' assessment was, and remains, correct. The inflation rate has fallen considerably since May. According to provisional estimates by Eurostat, it reached 2.4 percent in October 2001, a full percentage point lower than in May. Not only the ECB, but all international institutions are confident that price stability will be reestablished in the euro area in 2002.

Some of our critics, however, may argue that this does not represent proof that the ECB strategy is clearly understood. To this end, what matters is that monetary policy actions are correctly anticipated in financial markets. Only in this case one would be right to infer that the feedback mechanism from economic developments to policy decisions, which represents the essence of the monetary policy strategy, has been fully understood.

In practice, assessing the degree of predictability of policy actions is not a straightforward task. For example, one could observe that policy moves of a highly transparent central bank are difficult to predict during periods of particularly high uncertainty of the economic environment. Conversely, a central bank taking decisions randomly and without reference to any monetary policy strategy could still make itself predictable by simply pre-announcing such decisions.

Nevertheless, if the stability-oriented strategy were indeed too complex or ultimately opaque, as claimed by some of our critics, then we should expect monetary policy decisions to be very imperfectly forecasted by the markets. We should also expect a relatively high degree of volatility in the price of financial assets after the announcement of policy decisions. In contrast, a "normal" degree of volatility should be observed if the strategy is well understood.

Once again, the raw empirical evidence, reinforced by recent econometric studies, provides encouraging results. On average, the policy decisions of the ECB have been well anticipated, sometimes up to 3 months in advance judging from forward interest rates developments. A comparison with similar results obtained in other countries demonstrates that this is the best any central bank can strive to achieve, given the uncertainties of the economic environment in which it operates.

By and large, my positive assessment on the degree of credibility of the ECB and on the predictability of our policy decisions is shared by the various groups of ECB watchers, observers and commentators. While some of these were, and remain, critical of the ECB strategy, they all tend to agree that the strategy has ultimately been conducive to good monetary policy decisions.

A positive assessment can also be made regarding policy implementation. While not explicitly designed in order to cope with specific technical challenges, the operational framework worked smoothly during the Y2K period. The need for neither major changes in its structure, nor the introduction of new operational tools has so far emerged.

A global role

Given the size of the euro area economy, success at home has positive spillovers in the rest of the world. The ECB is aware of its global role – we are, after all, the central bank of the second largest monetary area in the world – and our decisions after the exceptional events of September 11 are there to signal such awareness.

Already on the evening of 11 September the ECB announced that it stood ready to provide additional liquidity to the markets. Commercial banks did become reluctant to pass on liquidity throughout the system in the face of uncertainty about future developments and the impact of the partial shut-down of US financial markets on the settlement of outstanding balances. In order to help restore normal market conditions and underscore confidence in the payments systems, the ECB injected liquidity in the system on 12 and on 13 September. These operations were performed through quick tenders, i.e. the instrument in the operational framework specifically tailored to address sudden liquidity shortages – or surpluses. On 13 September, additional dollar liquidity was provided through a swap agreement between the ECB and the Federal Reserve. These actions effectively contributed to a quick return to normal market conditions.

On 17 September the Governing Council decided to reduce the key ECB interest rates by 50 basis points, as part of a concerted action with the Federal Reserve. Other central banks of industrialised countries joined in with similar moves either on the same or on the following day. Given the potential global repercussions of the terrorist attacks and the uncertainty regarding their impact on the behaviour of economic agents across the world, a broadly similar response of central banks to the initial common shock – though obviously taking due account of differences in domestic economic conditions – was appropriate.

While providing an example of the ECB's awareness of the international repercussions of its policy, however, the decisions of last September were fully compatible with the efficient pursuit of our statutory objectives. Against the background of already subsiding inflationary pressure in the euro area, it was concluded that the terrorist attacks were likely to weigh adversely on confidence. The ensuing impact on the short-term outlook for domestic growth was likely to further reduce inflationary risks in the medium term. A prompt and relatively pronounced easing of monetary policy was therefore warranted in order to ensure that the initial shock would not translate into prolonged adverse effects on medium term trends.

The experience of the last three decades shows that episodes of international coordination are likely to remain exceptional and short-lived. There is in fact an increasingly widespread consensus, also owing to recent advances in academic research, that elaborate mechanisms for international policy cooperation may prove unnecessary, if all central banks make their best efforts to fulfil their domestic mandates. Given the limited capabilities of monetary policy and our imperfect understanding of the functioning of our economies, there is no known mechanism for international coordination which can do better than the independent maintenance of price stability in each country in order to ensure sustained growth in the world economy.

There is ultimately no trade-off between internal stability and global outcomes, likewise there is no trade-off between price stability and trend economic growth. Maintaining price stability, avoiding inflation risk premia, controlling inflation expectations are the best contributions of a central bank to domestic prosperity. These are also the best contribution to global stability.

Concluding remarks

The design of the monetary policy strategy most suited for a newly created monetary area poses a formidable challenge. The wide-ranging spectrum of opinions expressed in the debate on the strategy of the ECB proves this point in the euro area case.

While not universally consensual, the stability-oriented strategy reflects both the fundamental lessons from academic research and past policy experiences. It was designed with the aim to maximise the likelihood that we would be able to fulfil our mandate both during the exceptionally uncertain environment deriving from the introduction of the euro, and during more normal times – which are yet to come.

In contrast to the initial criticisms, there is now a general consensus, supported by the available evidence, that the strategy has been conducive to good policy decisions. We also see signs of constant improvements in the public's understanding of our strategy and decisions, also thanks to fruitful discussions with observers from different professions. In the context of the forward looking assessment of the risks to price stability which is an integral part of our strategy, the ECB has also demonstrated its international awareness in the face of exceptional events.

Yet, all our decisions are ultimately instrumental to the achievement of our final goal, the maintenance of price stability in the euro area over the medium term. They are only appropriate if our track record remains consistent with price stability over the relevant horizon. The high degree of credibility that the ECB commands in financial markets is a fundamental precondition to ensure that price stability will be a permanent feature of the euro area.