The art of central banking

Contribution by Hans Tietmeyer to the ECB Colloquium
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in honour of Otmar Issing

(1) Introduction

For some time now, appropriate and - above all - lastingly successful central banking has more and more often been classified and designated as an art. The label 'artist' for the active central banker is, however, not to be heard or read quite so frequently, apart perhaps from occasional references to Allan Greenspan as a great magician. In the case of Otmar Issing, too, I would not hesitate to speak of an artist of central banking. But – as in the case of Alan Greenspan, too – his outstanding professional and academic qualifications and powers of persuasion are inadequately conveyed by the concept of 'artist' alone. In his home town of Würzburg, where Mozart Festivals look back on a long tradition, there is unlikely to be, in the foreseeable future, competition in the form of an Issing Festival. Even so, I hope that his superlative achievements for the science of economics, and for the D-Mark and the euro, will be suitably honoured in the public sphere before long. After all, Otmar Issing, through many years of masterly and persuasive work, has provided theoretical and practical economics with numerous findings and insights. And, as a major architect of central banking, in Germany and especially in Europe, he has set unmistakable standards. Personally, I was privileged to co-operate with him directly for almost a decade, and learned a great deal from him, for which I remain grateful today.

(2) General assessment of ECB monetary policy

In today's globalised, fast-moving and multidimensional financial world, successful central banking has indeed become an art making heavy demands. That was and is especially true of the supranational ECB. It was, after all, a newcomer without any experience of its own when, in autumn 1998, only a few months after the establishment of the ECB, we on the Governing Council first defined the future monetary policy strategy, at Otmar Issing's suggestion, and then announced it to the public. And the ECB has in principle abided by that strategy ever since. After a thorough review, at all events, the Governing Council reaffirmed its basic stance in May 2003. Although a number of clarifications and concretizations were also approved, there was no fundamental revision or change of stance.

The definition of such a common strategy was anything but easy, particularly in the preparatory stage of the monetary union. Not only were the traditions of the national monetary policies highly divergent in some cases; the structures of the financial markets and the political and media environments in member states likewise showed not inconsiderable differences, and to some extent still do so today. And yet, the strategy jointly agreed at that time and its application in the practical implementation of ECB policy over the past seven years has to my mind been successful**, viewed as a whole**. It has contributed materially to the fact that the euro is today a well established and universally recognized currency. In some respects, the ECB has been able to link up with the experience of the national central banks, but in the meantime it has also acquired a distinct profile and standing of its own. At the same time, it has proved able to resist all overt and covert political assaults on its contractually-guaranteed independence. To that as well Otmar Issing has made a major contribution, together with his colleagues on the Board.

To this day, some politicians and journalists fail to understand that the causes of the weaknesses in growth and employment in the euro area in recent years certainly do not lie in monetary policy, nor can they be remedied thereby through faster monetary expansion. The structural weaknesses accumulated over decades (labour market rigidities, an excess of regulations, overburdened social security and taxation systems), and only partially offset so far- despite some major corrective efforts - especially in the larger euro economies, will have to be put right in the member states themselves.

This favourable general assessment of ECB policy naturally does not imply that it, too, need not be subjected to further professional discussion. There can and must not be any overall ban on debate in the field of monetary policy and its concrete implementation as long as the primary stability target remains in force. One aspect of the art of central banking is still a willingness to learn, especially from experience.

(3) Judgement versus rules in monetary policy making

(3.1) The case of Germany 1993-94

The main object and purpose of this panel is to reflect on the significance of 'judgement' in monetary policy practice. As a starting point, the organizers have asked each of the participants to report, in the light of their own experience, on monetary policy decision situations "in which there may have been little guidance from either history or theory, and where particular judgement was needed." The organizing committee was thinking of situations like "asset price collapses, financial crises, inflation scares, exchange rate crises, major political changes and big structural changes", such as for instance German reunion.

Needless to say, as Vice President and later as President of the Deutsche Bundesbank during the 1990s, I experienced quite a number of exceptional situations, and crises as well. Unlike other countries, Germany was largely spared "asset price collapses" and "financial crises" during those years. But we did have to cope with a number of "exchange rate crises" and a structural caesura of hitherto unprecedented scale, the reunion of western and eastern Germany, and the undesirable developments in German fiscal policy that were aggravated thereby.

However, this was for the most part a singular historical event, the lessons of which for monetary policy in general and for the policy of the Eurosystem in particular – despite the challenges it posed to the ERM at the time – are fairly limited. Hence I should like to draw your attention to a different critical period in German monetary policy in the 1990s which seems to me to be particularly suitable as an example of the importance of "judgement" or of "the art of central banking", and in mastering which Otmar Issing played a crucial role. I am thinking of the decision situation in the early months of 1994, when we at the Bundesbank decided to continue our policy of gradually lowering interest rates, even though the growth of the money stock at the time was much stronger than would have been consistent with the target corridor of 4 to 6%.

The situation around the turn of 1993-94 was marked by particular tension between easing inflationary pressures on the one hand and a sharp acceleration of monetary expansion on the other. A major reason for that was changes in national tax regulations at the end of 1993, which resulted in substantial return flows of financial resources from abroad and in a steep rise in the demand for housing loans. Under the impact of global interest rate increases at that time and of associated restraint in longer-term investments, this surge of liquidity developed into nothing less than a liquidity pile-up in early 1994.

After the monetary target had been overshot in 1993 for the second year in succession, according to the money stock management orientation of monetary policy prevailing in the Bundesbank at the time, at first sight the obvious step would have been to restrain the strong monetary growth by means of interest rate policy curbs. But things were not all that straightforward. In view of investors' uncertainty, and of expectations of interest rate increases at the long end of the market, we had to assume that an interest rate increase on our part would, if anything, tend to exacerbate the existing liquidity pile-up. Under those exceptional conditions, it was therefore essential to enhance interest in longer-term financial assets by increasing the interest rate gap between short and long-term investments, thus helping to dampen the growth of the money stock and the associated fears of inflation. After prolonged debate, we decided, at Otmar Issing's suggestion, to resume (after a break of several months) the policy we had begun in the autumn of 1992 of a gradual interest rate reduction, and between February and May 1994 we lowered our key interest rates in three steps (from 5 ¾ and 6 ¾ % to 4 ½ % and 6%). And after a comparatively short period, this policy led to a marked deceleration of monetary expansion.

The reason for this action by the Bundesbank at that time was not a new interest rate strategy and especially not a general setting-aside of potential-oriented monetary targeting. Instead, it was the appropriate answer to a specific situation in the financial markets, characterised by special factors. As a matter of fact, the interest rate stance of the Bundesbank (together with the rise in long-term yields) thereafter contributed significantly to the fact that the liquidity pile-up in the financial markets disappeared, and that the growth of the money stock returned to the target corridor by the end of 1994.

(3.2) The lessons of that experience

What lessons may be derived from that phase of German monetary policy? In the first place, of course, the example shows that strict pursuit of a rule once set is not always appropriate in monetary policy practice. It was not for nothing that we at the Bundesbank described our prevailing strategy of money stock management as "subjection to rules, with the option of discretionary action in exceptional circumstances" or "rule-based behaviour". We wanted to keep the option of flexible moves open.

Even so, for the Bundesbank it was always important to abide by the concept of fundamentally "rule-based behaviour". The reasons for such a concept were accurately defined as follows by John Taylor, the "inventor" of the Taylor rule, in his Carnegie-Rochester paper of 1993 [1]:

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[1] See Taylor, J. (1993): Discretion versus policy rules in practice, Carnegie-Rochester Conference Series on Public Policy 39, 195-214, p. 197

> "If there is anything about which modern macroeconomics is clear however - and on which there is substantial consensus – it is that policy rules have major advantages over discretion in improving economic performance. Hence, it is important to preserve the concept of a policy rule even in an environment where it is practically impossible to follow mechanically the algebraic formulas economists write down to describe their preferred policy rules."

Interestingly, in this context John Taylor also emphasized the similarities between interest rate rules of the Taylor type and money stock rules in the manner of Milton Friedman[2]. But that is only by the way. The crucial point for us at the Bundesbank was that rules – even if they cannot be abided by in certain situations – provide a major point of reference, which, in particular, serves to anchor medium to long-term inflation expectations. At the time, moreover, we always drew attention to the fact that the rate of monetary growth was only an intermediate target on the way to meeting the ultimate target, namely price stability. But the setting of a monetary target compelled the decision makers to provide convincing reasons for any failure to meet it, and thus created credibility with respect to the real mandate.

It may be argued, of course, that credibility depends less on words than primarily on deeds – that is to say, on visible successes in the matter of stability. In that respect, the Bundesbank was in a comfortable position in 1994 after many years of successful anti-inflation policy. And yet – and here, too, I know myself to be in agreement with Otmar Issing – a good "track record" alone is not enough to steer expectations in the desired direction. Rather must the "deeds" be bolstered by appropriate words – in the form of a clearly communicated definition of the ultimate objective and a consistent formulation of the monetary policy strategy.[3]

That brings us to another important aspect of the art of central banking, namely the role of communication. This is likewise a subject to which Otmar Issing has contributed a great deal. In his European function as well, he from the outset rightly emphasized the importance of transparency and communication for a newly-created institution like the ECB. At the same time, however, he always drew attention to the fact that there are distinct limits to any efforts at transparency. These limits result, firstly, from the substantial uncertainty about actual transmission mechanisms, especially in the international field, as well as from the low reliability of the available data base. Secondly, it must

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[2] See Taylor (1996), Policy Rules as a means to a more effective monetary policy,....

[3] See Issing (2004): Kommunikation, Transparenz, Rechenschaft – Geldpolitik im 21. Jahrhundert, Paper delivered at the annual meeting of the Verein für Sozialpolitik, (Society for Social Policy), p. 5

be borne in mind that enhancement of the data does not necessarily result in greater clarity. It is therefore imperative that the central bank should structure the mass of information bearing on any decision and release to the public not only the data but also its interpretation of such figures. This task is greatly facilitated in turn by the formulation of a consistent monetary policy strategy, which acts as a frame of reference for the interpretation of the varied data.

A special role is played by communication in the dealings of central banks with the financial markets. In this connection, all over the world there is an increasing tendency for the markets to be prepared for future interest rate changes by hints in speeches and publications. The object of this development is to steer market expectations in the direction desired by the central bank, although, needless to say, that can be accomplished only if the public statements are actually consistent. This cannot mean, however, that every monetary policy measure can be prepared well in advance, and can be completely foreseeable. Instead, situations are conceivable in which surprising monetary policy decisions are essential, for instance in order to prevent unwelcome developments in the financial markets. Hence, central banks must retain the freedom not necessarily to share the assessment of the markets, but rather to determine the basic orientation of market expectations themselves.

(4) Monetary policy and asset prices

As mentioned above, during the era of money stock management (1975 – 1998) Germany was largely spared sharp fluctuations in asset prices, and financial crises such as erupted in many other countries in that period. I am thinking, for instance, of the crash in the early 1990s, from which the Japanese economy has not fully recovered up to this day, and of the asset price bubble of the late 1990s, which started in the USA and spread to many other countries. I have no wish to speculate here on how great the contribution of our monetary policy strategy was to the superior stability of asset prices and the financial system in Germany at that time, and on whether it was not other factors that fostered such stability. On the other hand, the fact should not be disregarded that both the crash in Japan and the bubble in the USA were preceded by a distinct acceleration of monetary growth, which – seen with hindsight – should perhaps have deserved more attention than it received at the time. (In the USA the growth rate of M3 rose from 1.4% in 1994 to 10.4% in 1998.)

Fluctuations in asset prices which do not appear warranted by corresponding changes in the fundamentals give stability-oriented central banks cause for concern for several reasons. For one thing, they distort the price mechanism, and therefore impede the efficient deployment of resources. For another, the bursting of an asset price bubble may jeopardize the stability of the financial system, which may generate huge costs, in the form of a period of economic contraction – in the worst case, of a slide into deflation.

Against this background, central banks must grapple with the question of whether and, if so, when and how they should respond to expected undesirable developments in asset prices. Any answer to this question is complicated, firstly, by the fact that the identification of financial market bubbles – which often prepare the way for a crisis – is exceedingly difficult. Moreover, our knowledge of the real economic implications of financial disequilibria – notwithstanding all the empirical and theoretical research efforts of the past few years – is still very limited.

Both these facts suggest in general that central banks should respond to asset price fluctuations – if at all – only very cautiously. For instance, Alan Greenspan, who guided the US economy through the bubble of the late 1990s, always viewed the possibility of stopping an emerging bubble by monetary policy means very sceptically. For that reason, he argued in favour of first waiting for the bubble to burst, but then – if necessary – intervening quickly and resolutely to moderate any adverse consequences, such as an impending deflation ("mitigating the fallout when it occurs").

It is true that I agree – as I suppose most of you do as well - with Greenspan that it is extremely difficult to diagnose unwelcome developments in asset prices in real time. Yet I assess the options available to prophylactic monetary policy not quite so sceptically as Alan Greenspan – and in this I know myself also to be in agreement with Otmar Issing. Allow me to list a number of reasons for this. In the first place, central banks monitor developments in the financial and real- property markets very carefully, and clearly possess a number of indicators that point to potential unwelcome developments. Secondly, the general monetary and financial environment must also be included in any analysis of asset price movements. As past experience has shown, the emergence of price bubbles is very commonly accompanied by excessive credit and liquidity formation. Hence the monitoring of money stock and credit aggregates is in my view of paramount importance in identifying undesirable developments in asset prices.

Against this backdrop, the twin-pillar strategy of the Eurosystem appears suitable in principle for detecting "unhealthy" developments in the financial markets in good time, and for forestalling them by means of monetary policy measures. For one thing, this is because the ECB, in the context of its economic analysis, analyses movements in asset prices and their impact on assets, capital costs and balance sheet items and – through these channels – on consumption and investment. For another, also because it assigns to the analysis of the money stock and lending an important role in the assessment of the medium to long–term prospects for price movements. By counter-checking the regular economic analysis by reference to the monetary analysis, the length of time over which the ECB assesses consumer price movements is extended. In this way, the ECB can also cover the significance of asset price movements, which are reflected in consumer prices only over the medium to long term.

Hence the ECB, with its twin-pillar strategy, not only serves price stability in the stricter sense but at the same time helps to safeguard financial stability.[4] In principle, to be sure, I must warn against extending the mandate of central banks – as is sometimes done – to objectives other than the safeguarding of price stability. And yet, with reference to financial stability (and also with reference to the target of output stabilization), it is true that a conflict between that target and the objective of price stability, which may exist in the short run, will disappear as long as the definition of price stability covers a sufficiently long horizon. Evidence that price stability and financial stability do not impede each other in the long run, but rather foster one another. is incidentally provided by the high level of price and financial stability, by international standards, that was reached in Germany between 1975 and 1998 – during the era of money stock management.

However, as regards the important issue of monetary policy, asset prices and financial stability, many questions still remain unanswered. Otmar Issing has voiced a number of them as follows:

> "What is the transmission mechanism of asset prices to the real economy and their information content for future inflation and output? How large are the risks for extreme outcomes following significant asset price corrections? What are the channels for possible systemic contagion effects of asset price busts? What is the role of banks in the asset price transmission mechanism? How do money and credit behave over an asset price cycle? Against this background, how should central banks act and communicate with regard to asset price developments?"[5]

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[4] See White, W. (2006): Procyclicality in the financial system: do we need a new macrofinancial stabilisation framework?, BIS Working Papers, No. 193, p. 15.

[5] Issing, Otmar (2003): Introductory statement at the ECB Workshop on „Asset Prices and Monetary Policy", Frankfurt am Main, 11/12 December, 2003, p. 8f.

Finding constructive answers to these open questions is of course primarily a task for academic economists. But it is often a part of the practical art of central banking to act and communicate before all the details have been clarified academically. To this extent, the art of central banking also occasionally includes progress through trial and error, although particular caution is called for in this case because of the potentially far-reaching consequences.

(5) Conclusion

If you ask me to sum up the lessons I draw from my own experience as a central banker, I find myself in full agreement with Otmar Issing, who has very nicely summarized the core messages as follows:

- don't try tricks, don't try to be too clever;
- keep steady, keep committed to your mandate, even in exceptional circumstances;
- say as much as you can about what you are going to do: announce a strategy;
- don't be dogmatic, but follow a policy which is always in line with your strategy.[6]

(6)Thanks to Otmar Issing

The prospect, which will very shortly become reality, that Otmar Issing will be following the labours of the ECB only as an observer, from the outside, implies of course that he will no longer be participating as an active artist in the practical design and implementation of monetary policy. But I am utterly convinced that the subject will go on obsessing him in his future economic and journalistic work and - in the interest of all of us - should continue to do so.

Already at this juncture, I should like to proffer him thanks for his sterling efforts at the ECB. Along with his staff, and under particularly difficult conditions, he significantly shaped and enriched the art of central banking, not just in theory but notably also in the difficult day-to-day practice of a new supra- and multi-national institution. The high quality of his analyses, his unequivocally stability-oriented stance, his clear diction and his cooperative style of work contributed materially to the fact that the ECB now enjoys a high reputation word-wide, and that the euro is a stable and globally recognized currency. I – speaking as someone who worked for almost 30 years on the preparation of the monetary union – am most particularly grateful to him, his colleagues and his staff for that fact.

[6] Issing,Otmar (2003): Monetary policy in uncharted territory, Stone Lecture, London, 3 November 2003