Issing's Swan Song

TIE asked this distinguished policymaker for his final defense of the European Central Bank's two-pillar strategy.

BY OTMAR ISSING

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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The European Central Bank was established to take responsibility for a new currency, the euro, as of January 1999. To overcome some of the inevitable uncertainties and even skepticism surrounding this enterprise, in the autumn of 1998 the Governing Council of the ECB described to the public how it would organize its assessment of the economic situation and prospects in order to arrive at its monetary policy decisions. This monetary policy strategy soon became famous for its "two pillar" structure. But why two pillars?

The Maastricht Treaty assigns the European Central Bank a clear mandate, namely to maintain price stability. Because of the long and variable lags in the transmission of monetary policy to price developments, a central bank can only control inflation over the medium term. In order to do so, its decisions have to be taken in a forward-looking manner, so that monetary policy actions have an appropriate impact on price developments when the lags in transmission unwind. Against this background, the permanent challenge facing monetary policymakers is to assess future risks to price stability on the basis of the data available now.

These risks derive from many sources. One set of sources—such as developments in import prices (e.g., energy), changes in administered prices and indirect taxes, wage dynamics, etc.—have an impact on the prices of goods and services in the shorter-term, say within a year or two. A comprehensive assessment of these risks is made by

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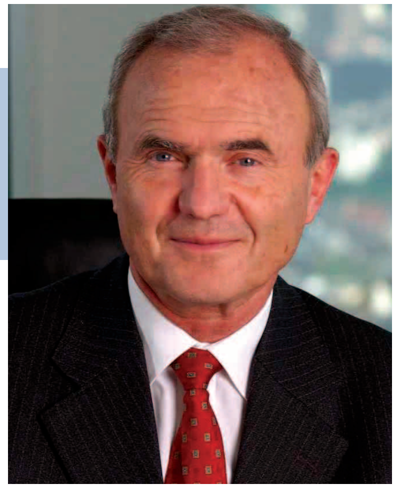

Otmar Issing, *soon-to-retire member of the Executive Board of the European Central Bank argues a central bank cannot afford to ignore the information in monetary developments in formulating monetary policy.*

the ECB in the context of its "economic analysis"—one pillar of its monetary policy strategy.

At the same time, other sources—notably monetary developments—pose risks to price stability at medium to longer horizons. Extracting the policy-relevant information about longer-term trends in inflation contained in monetary data is the core task of the ECB's monetary analysis—the other pillar of its strategy.

Playing down the importance of "money" in macroeconomic developments has become a fashion, an attitude which seems to be endorsed by mainstream academic macroeconomics. In my view, this fashion has gone too far. We should rather ask the question: Can a central bank afford to ignore the information in monetary developments in formulating monetary policy? To me, the answer is straightforward: No.

On the contrary, there are many reasons why a central bank should monitor the development of money carefully. Not least, the theoretical and empirical evidence accumulated over decades supports the view famously taken by Milton Friedman: "Inflation is always and everywhere a monetary phenomenon." Or, as Mervyn King, Governor of the Bank of England, has more recently stated in the title of a speech: "No money—no inflation."

It is time to move on from the misguided question of whether analysis of monetary data should play a role in monetary policy making. This has proved to be an unfortunate distraction from the real issue: how to conduct a monetary analysis and integrate it with other parts of the overall assessment in a manner that offers the best support for monetary policy decisions.

Monetary analysis is crucial in reaching a good understanding of the medium- to longer-term outlook for price stability.

The term "money" is used here to refer to the full set of information stemming from the monetary sector, which includes a wide variety of monetary aggregates as well as data on credit and other financial flows. Experience has shown that reliance on a specific definition of "money" in a rapidly changing financial environment can be misguided. A crucial component of the monetary analysis conducted at the ECB is the attempt to identify the underlying trend in monetary developments—the true signal from "money" broadly defined—from the set of available monetary, financial, and economic data.

The "two pillar" approach adopted by the ECB reflects the need for an encompassing assessment of the economic situation, embodying an important and distinctive role for monetary analysis. Since the announcement of its strategy in 1998, the ECB has gained considerable experience with the operation of its strategy. In particular, it has found that monetary analysis is crucial in reaching a good understanding of the medium- to longer-term outlook for price stability. Using monetary developments to cross-check the economic analysis from this longer-term perspective is fundamental in coming to a comprehensive judgment of the risks to price stability that lie at the core of a meaningful monetary policy analysis.

Developing such a rich monetary analysis is naturally complex, and complexity inevitably creates communication challenges. The ECB recognized this from the outset. As with the broad range of indicators used in the economic analysis, it has always been transparent about the complexities involved. In our communication with the public, we always strive to offer clear—but not simplistic—messages about the conclusions

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drawn from the monetary analysis, which accurately reflect the intricacies and challenges that we face.

And over the past almost seven and a half years, in the context of significant global shocks and major changes to the structure of the economy, these challenges have been substantial—although hardly unique to monetary analysis. Confronting such challenges has proved a demanding task, but one which has produced substantial rewards. Two in particular stand out.

First, our monetary analysis has delivered important signals about the outlook for future price developments, especially at the medium to longer horizons most relevant for monetary policy decisions. Since 1999, the indicator properties of money for inflation in the euro area (as derived using the available tools) compare very favorably with alternative frameworks, such as macroeconomic projections and forecasts. In particular—and in line with the view that monetary developments are more important at longer horizons, whereas other factors dominate in the shorter term—the monetary analysis has tended to make a more accurate assessment of the average level of inflation than macroeconomic forecasts, even if it has not captured the quarter to quarter movements so well. Of course, the period of comparison is still relatively short, given that Monetary Union only started in 1999. Definitive conclusions cannot yet be drawn. But it is striking that those who take the time to evaluate the data carefully—including some who started as skeptics—reach the same conclusion: monetary developments do contain policy-relevant information.

Second, the monetary analysis has provided a framework within which to identify, discuss, and communicate in a timely way the growing challenges posed by financial imbalances and inflated asset prices. It has become widely

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recognized that, with consumer price inflation well-anchored, overly accommodative monetary policies may find their expression in asset price inflation. Over longer horizons, this may prove extremely hazardous to price and macroeconomic stability. Further research in this area is of course needed, and the ECB is active in this regard. Nonetheless, taking monetary analysis in a broad sense seriously is, in our experience, an important step in making headway with this agenda.

I am convinced that the ECB's monetary analysis therefore addresses major shortcomings of other monetary policy strategies. It helps to lengthen the horizon of the policymaking discussion and provides a framework for considering asset price and financial imbalances. Indeed, other central banks are considering using a cross-check based on money, credit, and asset market developments in their policy frameworks to address precisely these concerns. Monetary analysis therefore is an important component of how central banks will face the challenges of the future.

At a recent conference organized by the ECB, which was attended by many leading academics and central bankers from all over the world, many of the contributions acknowledged the need for an important "role for money" in monetary policy making and macroeconomic analysis, although opinions differed on how best this should be achieved. Overall, one sensed a widespread understanding of and sympathy for the ECB's approach. I do not claim that the ECB has found the solution to embodying the assessment of monetary developments into the framework for monetary policy decisions. But the ECB has taken a lead in addressing this challenge. And, drawing in part on its monetary analysis, the ECB's conduct of monetary policy on the basis of its two-pillar strategy over the first almost seven and a half years of monetary union has achieved very satisfactory results in maintaining price stability. ◆