Objectives and challenges of monetary policy: a view from the ECB

Speech by Jürgen Stark, Member of the Executive Board of the ECB
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Ladies and Gentlemen,

It is with great pleasure that I accepted the invitation by Magyar Nemzeti Bank to come to Budapest for this conference, marking 10 years of inflation targeting at the MNB and marking György's departure as Deputy Governor after a very distinguished career.

Next year, the ECB will mark the 10th anniversary of its creation and of the announcement of our own monetary policy strategy which represents a distinct approach in a number of respects. I will use the privilege of the opening session to this conference to offer a few broader reflections on the objectives and challenges of monetary policy from the ECB's perspective, which – almost inevitably – will touch upon the famous three Cs of central banking: credibility, consistency and continuity.

Since its first inception in New Zealand at the beginning of the 1990s the concept of direct inflation targeting has rapidly spread across the globe and has become an impressive success story since. There is a first point worth recalling, however: in most cases inflation targeting was initially born out of the failure of previous policy regimes, most commonly exchange rate targeting. This often implied the need for a clear break and fresh commitment to re-establish credibility with respect to the earlier policy regimes. In the case of Magyar Nemzeti Bank the shift of focus from exchange rate orientation towards inflation targeting seems to have been more gradual than elsewhere, but also not without occasional turbulence along the road.

The ECB could thankfully rely on a strong record of success by our best performing predecessor central banks. This suggested to place emphasis on continuity in order to preserve credibility. At the same time, the ECB as a new institution faced a deeper set of uncertainties in managing a new currency area. It could not be taken for granted that previously established economic relationships and regularities would

continue to hold after the transition to monetary union, since – as implied by the well-known "Lucas critique" – a change in policy regime as significant as the introduction of a new currency was likely to affect the behaviour of the private sector. This placed a premium on choosing a strategy framework that would prove robust to changing circumstances and would continue to stand the test of time in the face of new challenges. Looking back on our experience, the ECB's strategy has proved its worth in offering a systematic framework for practical policy-making which combines continuity and consistency with sufficient in-built flexibility, well-equipped to address future challenges.

A second, related point is worth recalling: only after the first central banks had already (been) plunged into the new world of direct inflation targeting did an increasingly sophisticated intellectual machinery in support of inflation targeting develop in the academic literature. Since then, inflation targeting seems to have become the dominant benchmark for discussions of monetary policy, both among practitioners and in academic circles. The symbiosis between academic research and modelling and central banking practice has no doubt been highly fruitful. At the same time, policymaking in practice will always be forced to confront new challenges in real time and will have to take into account factors outside the realm and limitations of formal modelling and forecasting. It must also be noted that both the theoretical representation of inflation targeting in the literature and inflation targeting in central bank practice have evolved significantly over time.

Against the background of these two preliminary remarks it may be a bit less of a puzzle why the three major central banks in the world, the U.S. Federal Reserve, the Bank of Japan and the European Central Bank, have continued to resist to embrace the label "inflation targeting" to characterise their own distinct approaches to monetary policy making. To mind, at any rate, the degree of consensus and commonalities in the approach to similar challenges confronted by all major central banks is much greater than some of the labels and the academic discussions might suggest.

This broad consensus applies certainly to the question of the appropriate objectives of monetary policy, which I will discuss in the first part of my talk. An appropriate definition of objectives is the starting point of any monetary policy strategy, and here

some differences exist across inflation targeting central banks and other strategies. Differences become somewhat more pronounced when it comes to describing the way to go about achieving the primary objective or target as defined. As I will discuss in part two, the ECB's two-pillar approach has served us well in practice even though it continues to attract academic criticism as being outdated or redundant. Quite on the contrary, I will argue that this approach offers a valuable longer–term cross-check with respect to conventional macro-economic models and tools. Our strategy also appears to offer a suitable platform to take into account some of the challenges, which have gained prominence more recently, such as those related to asset prices, financial imbalances and financial stability considerations more broadly. Finally, the strategy also provides a suitable basis for accountability vis-à-vis the public and consistent communication of monetary policy vis-à-vis the financial markets.

1. The primary objective of price stability

There is a widely shared consensus on the need to maintain a clear focus on price stability, as the "magnetic north" of our compass, as Jean-Claude Trichet likes to put it. This consensus also applies to the need for sound institutional foundations of central bank independence, where the Maastricht Treaty has set high standards. Specific institutional features of central bank independence will, however, obviously vary across different constitutional traditions and provisions, say in the US or in the UK. In the European Union, it was essential to have these principles well-entrenched in the Treaty. Nevertheless, there still seems to be an occasional need to remind politicians, who after all had committed to these very principles as the conditio sine qua non of monetary union in the first place.

With a clear focus on price stability over the medium term – as emphasised by the ECB's strategy – monetary policy can be most supportive to sustainable and stable growth and employment creation. It is important to recall there is no long-run trade-off between output and inflation but, on the contrary, maintaining price stability and real economic objectives are complementary in the long run. Price stability enhances the working of the price mechanism and promotes efficiency in the allocation of resources. Price stability also minimises the inflation risk premium in long-term interest rates and preserves the purchasing power of consumers and wage-earners. Through all these channels the maintenance of price stability contributes to creating

favourable conditions for sustainable economic growth. The absence of a long-run trade-off between inflation and growth is also the key theoretical basis for delegating monetary policy to an independent central bank. Otherwise, in a democratic system it would be hard to justify to take the exercise of normative judgement in determining choices about long trade-offs outside the control of the political process from the perspective of democratic legitimacy.

At the same time, focusing on maintaining price stability over the medium term will also tend to contribute to cyclical output smoothing as a by-product. In particular, higher-frequency fluctuations in prices – which are in any case largely beyond the control of monetary policy – can be accommodated. Thus a concern with avoiding unnecessary fluctuations in real economic variables is taken into account in the medium-term orientation of the monetary policy strategy and in the need to calibrate the appropriate monetary policy response to the nature of shocks allowing for gradualism in restoring price stability.

A similar complementarity of objectives – at least over the medium to longer term – also broadly applies to the relationship between price stability and financial stability, an issue that has received increasing attention in recent years, not least in the work of the BIS. However, experience shows that the maintenance of price stability is a necessary but certainly not a sufficient condition for the stability of the financial system. Indeed a low inflation environment does not preclude the build-up of financial imbalances such as in conjunction with pronounced movements in asset prices as witnessed in the context of the high-tech bubble in global equity markets in the late 1990s. Such imbalances can be costly to unwind and may also carry risks to price stability from a longer time perspective, e.g. in the context of debt deflation as highlighted by Irving Fischer in his analysis of the Great Depression. While there is again a broad consensus among central banks that it would be inappropriate for monetary policy to target asset prices there is increasing recognition that such longer-term considerations cannot be easily taken into account within the standard inflation forecast targeting framework. In this context, the attention paid by the ECB to the analysis of money and credit as a gauge of longer-term inflation risks is valuable as an early warning signal in the context of identifying and possibly attenuating unhealthy boom-bust cycles in asset markets, which have typically been associated

with concomitant expansions of money and credit aggregates (Adalid and Detken, 2007).

Any discussion of the ECB's mandate and strategy also has to take into account the broader, more complex institutional set-up in the euro area, which at present comprises 13 sovereign states. The competence for monetary policy is allocated to the Union level and delegated to the ECB as an independent institution with the primary objective of maintaining price stability. By contrast, responsibilities for fiscal policies, labour market policies and structural policies largely remain rooted at the national level. At the same time, the Treaty – in conjunction with the Stability and Growth Pact – subjects national fiscal policies to a set of common rules and surveillance procedures. This reflects the need for a common framework for sound public finances inside the monetary union as an essential complement to lasting monetary stability.

Since the Treaty defines price stability as the primary objective of the ECB, in October 1998 the ECB, as the first element of the strategy, announced a quantitative definition of price stability. Price stability was defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% to be maintained in the medium term. The ECB's pursuit of price stability over the medium term recognises that monetary policy cannot control price developments in the short run and that attempts to fine-tune inflation or economic activity would be destabilising.

The ECB regarded it as important to provide a numerical benchmark for accountability and as a firm anchor for inflation expectations right from the start. The Governing Council's evaluation of the monetary policy strategy, concluded in May 2003, confirmed the quantitative definition of price stability. At the same time it was made clear that the ECB aims at an inflation rate of "below, but close to, 2%" in order to maintain a sufficient safety margin to guard against possible risks of deflation.

The clarification of May 2003 has thus introduced an additional, qualitative, indication ("below, but close to 2%") to supplement the quantitative ceiling established from the outset. The ECB's definition, while providing a quantitative benchmark, allows some room for judgement. In particular, the emphasis on the medium-term horizon over

which the objective is pursued helps to avoid the (misleading) impression of an automatic feedback from a numerical target at a particular horizon. This reflects the need to tailor the appropriate monetary policy response to the source and nature of shocks that are hitting the economy, rather than being determined mechanically by a particular numerical value of an inflation forecast at a specific horizon.

For example, there may be a number of circumstances, such as favourable supply shocks for which a prolonged (but limited) undershooting of an inflation target could reflect an equilibrium phenomenon. In such circumstances, seeking to force inflation back up "artificially" could contribute to the build-up of imbalances elsewhere in the economy, e.g. with regard to asset prices. Such a prolonged undershooting of the inflation target seems to have been associated with a perceived need for policy tightening coming from a longer-term perspective in a number of inflation targeting countries in recent years, including the UK, Sweden, Norway and New Zealand. In many of these episodes attention to asset prices, namely developments in housing markets, seem to have played a role. This has prompted some inflation targeting central banks to extend their forecasting horizons and/or to introduce "exception clauses" in their frameworks in order to accommodate temporary deviations of inflation from target in special circumstances.

2. The ECB's two-pillar approach

The clear priority given to the objective of price stability by the Treaty and the key role of a quantitative definition of the primary objective are also common features of inflation targeting. Incidentally, in this respect the German Bundesbank and the Swiss National Bank – the principal pioneers of monetary targeting in the 1970s – had set high standards of low and stable inflation long before inflation targeting was invented. However, especially as portrayed in the academic literature, inflation targeting is also often seen to entail specific procedures or policy rules for interest rate setting, e.g. in relation to inflation forecasts at specific horizons or in the context of specific models or communication practices. The ECB has always rejected any such simplified representation in the context of our two-pillar approach. This has remained a rather unique trademark, if you will, even though more recently the Bank of Japan's strategy announcement regarding their use of two "perspectives" referring to different time

horizons in guiding monetary policy decisions seems to bear some resemblance with our approach.

In the case of the ECB's strategy, the assessment of risks to price stability is based on both economic analysis and monetary analysis, i.e. two complementary perspectives which have early on been dubbed the "two pillars" of the ECB's strategy. The economic analysis focuses mainly on the assessment of current economic and financial developments from the perspective of the interplay between supply and demand in the goods, services and factor markets. In this context the macroeconomic projections serve to structure and synthesise a large amount of economic data. However, they are not seen as an all-encompassing tool for the conduct of monetary policy. In this vein, the projections are produced under staff responsibility as an input into the deliberations of the Governing Council. Twice a year they involve a broad exercise involving extensively also all the national central banks in the Eurosystem, while the remaining two exercises are produced at the ECB. These staff projections are now published four times a year.

The monetary analysis serves as a means of cross-checking, from a medium to a long-term perspective, the short to medium-term indications coming from the economic analysis. In October 1998 the ECB assigned a prominent role to money in recognition of the close association between monetary growth and inflation in the medium to long run. Information from money and credit may help to identify risks to price stability at time horizons beyond those usually covered by conventional macroeconomic projections.

The prominent role assigned to money in the ECB's strategy has been signalled by the announcement of a reference value for monetary growth. The reference value provides a rough benchmark around which a much broader set of analyses of money and credit is conducted. Grouping the monetary analysis under a distinct pillar helps to ensure that information on monetary developments is given appropriate weight in the decision-making process and is not crowded out by shorter-term considerations. From the outset, the Governing Council has stressed the medium-term horizon of the monetary perspective and emphasised that there is no mechanical link between short-term monetary developments and monetary policy decisions. The monetary analysis involves a detailed analysis of money, its components and counterparts with

a view to identifying the underlying trend and the relevant signal for price developments at longer horizons.

The ECB's approach underscores the importance to consider price stability at longer horizons and to take into account a broad range of transmission channels, not least in the context of monetary factors driving price trends and/or financial imbalances, for example, in conjunction with asset price cycles (Borio and Lowe, 2002). The build-up of financial imbalances and large swings in asset prices pose a challenge to conventional inflation targeting frameworks (Bean, 2004) pointing either to the need to extend the relevant policy horizon or to make use of escape clauses from inflation targets under exceptional circumstances as mentioned above.

The ECB's two-pillar strategy is one way to organise a broad-based analysis in a systematic and transparent manner. Under inflation targeting most analysis would tend to be channelled via the forecast process. However, conventional forecasting exercises are typically conducted in the context of models where inflation is, to a large part, driven by short-run cyclical developments in activity and other real variables, with a limited role for money and financial variables. These models and forecasts do not assign a role to money and credit in influencing risks to price developments at longer horizons and at lower frequency. They also increase the temptation to engage in demand management, which may, in the end, prove destabilising in the face of significant uncertainty and limited knowledge about the "true model" and underlying relationships and concepts like potential output, the output gap or the NAIRU. Inflation forecasts based on the output gap are particularly prone to suffer from the inaccuracy of data and estimates available in real time.

While, of course, also many inflation targeting central banks look at the information coming from money and credit, up to now it has not proved possible to integrate the monetary side into the inflation forecast in a convincing manner, just as attempts to integrate monetary phenomena into New-Keynesian models have proved challenging. Thus, in order to avoid that this information is crowded out in conventional forecast exercises, there may be some merit in providing a distinct avenue to bring monetary analysis to bear in the policy process as in the approach chosen by the ECB.

The ECB's two-pillar strategy can be seen as a good example of a more procedural notion of a monetary policy framework (ECB, 2001). It is hard to fit in any category in the spectrum of simple vs. optimal rules or instrument vs. target rules or "simple feedback" vs. "forecast-based rules" in the words of Bernanke (2004) and as discussed in the academic literature. This meant that the ECB's strategy has certainly proved to be not easily digestible to academics. The strategy explicitly shuns the notion of a dominant model or all-encompassing forecast often associated with inflation targeting as well as simple, mechanical rules of the Taylor type or as under traditional monetary targeting. The ECB's strategy puts a premium on the notion of robustness and the need for complementary perspectives and approaches to inform the policy process. This makes it certainly look more complicated and more difficult to communicate than at least the simpler representations of inflation targeting. At the same time, the strategy acknowledges the need for an effective structuring of information, as in the two-pillar framework. It also gives a role to simple guideposts, like the medium-term reference value for money and regular staff projection exercises as a way to condense a large (but not all-encompassing) amount of information. The strategy emphasises procedural notions, such as the stress on "cross-checking" of information coming from the two pillars.

From this perspective the two pillars of the ECB's strategy offer a way to bring together and compare different analytical perspectives and to use – and present – all the information relevant to decision-making in a systematic way. The two-pillar structure of analysis and communication is, admittedly, more complex than the unitary, more monolithic message conveyed by inflation targeting at least in the simplest earlier vintages. At the same time it arguably provides a more explicit and stable framework than an eclectic multi-indicator approach of "looking at everything".

3. Challenges and prospects

To my mind, the announcement of the ECB's monetary policy strategy has been key in establishing credibility from the very beginning. The strategy provides a solid basis for consistency and continuity in decision-making over time and an open, flexible platform for discussion. The two-pillar structure, in particular, explicitly acknowledges and facilitates the need to cross-check and reconcile different time perspectives and analytical approaches. It may still seem premature to include the notion of cross-

checking among the all-important Cs of central banking. However, I sense that the merits of cross-checking as a way to enhance robustness gain increasing recognition. How to best structure and reconcile the cross-checking of different perspectives - both from a conceptual and practical point of view - remains an ongoing challenge for all central banks.

In the final analysis the success of a monetary policy strategy, obviously, has to be measured against the results that it delivers. The average annual increase in the HICP since the launch of the euro has been just a shade above 2%, which is a significant achievement in view of substantial adverse price shocks during this period. Moreover, following the disinflation and convergence process in the run-up to Monetary Union, long-term inflation expectations have been stable and anchored at levels broadly consistent with the definition of price stability bearing testimony to the ECB’s high level of credibility, day by day.

To be fair, both inflation targeting central banks and major central banks following a distinct approach, like the Federal Reserve and the European Central Bank, have had considerable success in achieving stable prices in recent years. For the ECB, taking over responsibility for a new currency area, this success could not be taken for granted. The ECB also shares the broad consensus in the central banking community with respect to the importance of transparency and active communication. We have been pioneers in providing detailed explanations of monetary policy decisions almost in real time in the context of the President's press conferences right after Governing Council meetings. We also publish extensively and comment on data developments at a high frequency in our Monthly Bulletin as well regularly explaining our policies in the context of the ECB's reporting to the European Parliament.

The appropriate basis and framework for transparency and communication is the mandate given to the ECB by the Treaty and the strategy that we have announced in order to deliver on that mandate. This provides the elements for the public and the markets to assess our performance on an ongoing basis. In line with the evolving practice in a number of central banks, our communication efforts relate both to explaining decisions already taken as well as providing some indications and forward orientation on future prospects on the basis of our monetary policy strategy. Such guidance takes the form of qualitative statements included in the ECB’s Introductory

Statements and conveyed in the press conferences. This ECB approach maintains our freedom to always act to do what is necessary to maintain price stability.

Overall, the idea of a single "best practice" or universal textbook recipe to monetary policy and communication across the globe seems ill-advised to me. Here I am tempted to refer to Frank Sinatra on our way, the ECB's way, to go about monetary policy and communication. On the basis of credibility, consistency and continuity, and on the strength of our experience to date, I believe we are indeed well equipped to face future challenges. I am confident that our approach is flexible enough to adapt to changing circumstances while also providing an element of insurance against fads and fashions in the economics profession. In particular, we are well-advised to retain an element of caution against overconfidence in the ability of monetary policy to engineer and fine-tune economic developments with a great deal of precision. The key to successful and credible monetary policy has always been not to promise more than central banks can deliver. It is worth heeding the lessons of the past in this respect. After all, in the heydays of macroeconomic management during the 1960s the Phillips Curve was largely uncontested. Incidentally, the painful return to a less ambitious attitude towards macroeconomic policy in the 1970s and 1980s was associated with the re-discovery of the role of money in the economy. Also in our times, I believe we can ill afford to take the eyes off the ball on the fundamental long-run relationship between money and inflation, even as this relationship may become increasingly difficult to uncover in an environment of price stability and financial innovation. Perhaps the most delicate challenge for central bankers today remains to avoid hubris in the wake of the tremendous progress we have seen in stabilising inflation and to avoid falling victim to our own success.

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