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Central Bank Independence and Monetary Policy in a Low Inflation Environment

Stanley Fischer[1]

1. Thank you. It is a great pleasure to be here, participating in this conference, which comes at a critical time in the process of European monetary integration. EMU is of major economic importance, and it is entirely appropriate that, in conferences like this one, the economic issues associated with it be analyzed with all the intensity and rigor of which our profession is capable. But the success or failure of EMU has implications that go far beyond economics--for EMU is now the vehicle on which the political future of Europe rides. For good or ill, one can only admire the boldness of the decision that tied the process of European integration to the unprecedented creation of a multinational currency, thereby raising the costs of failure to a level that helps assure the success of the project.

2. The politics points against the failure of EMU, and at least for that reason, so does the economics. I will return to that subject at the end. But first, let me talk about central bank independence and monetary policy in a low inflation environment. I will focus the discussion on the monetary policies of the ECB.

3. The ECB has been given a mandate to maintain price stability (Article 105 of the Maastricht Treaty). It is also required to support general economic policies in the Community, whose goals are described in the Treaty (Article 2) as being "to promote a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States". Fortunately, Article 105 includes the caveat that these goals should be pursued "[w]ithout prejudice to the objective of price stability".

4 Taken literally, price stability means stability of the price level. But no central bank has the goal of maintaining a constant price level, and in practice price stability is interpreted as a low rate of inflation. Just how low should that be? The arguments for a low rate of inflation are clear:

- standard distortion costs of inflation;
- the Feldstein arguments, which are however more about the taxation of capital than about

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[1] First Deputy Managing Director, International Monetary Fund, Washington, DC. This is the outline of a lecture delivered at the conference on "Central Bank Independence and the Credibility of European Monetary Policy", at the Austrian National Bank, Vienna, on May 13 1997. Views expressed are those of the author and not necessarily of the International Monetary Fund.

target rates of inflation, and the cure is indexation of capital taxation;

- inflation is bad for growth at high inflation rates.

These arguments suggest going to zero -- indeed to less, for there are arguments in the economics literature suggesting the optimal rate of inflation is negative.

Why not go to zero?

- the evidence on inflation and growth is quite mixed at low rates of inflation;

- the possibility that the Phillips curve is not vertical at zero inflation (Akerlof, Dickens and Perry, or ADP).

While there has been some controversy about the ADP arguments, I believe they do provide relevant evidence about downward wage inflexibility in the U.S. economy, and that they provide one good reason not to set a zero inflation target in the United States. At the same time, we should recognize that nominal wage inflexibility is not a structural feature of an economy, and that we should expect the downward flexibility of wages to increase as the economy gets used to operating at a very low inflation rate.

These arguments about downward wage and price flexibility were made for the United States. But they are relevant also for Europe, where wage inflexibility and the lack of labor market flexibility are widely recognized as serious problems. EMU will not lead to better economic performance until European markets become more flexible--and there should be no underestimating the significance of this point. Countries are giving up one sometimes important means of adjusting to shocks, the exchange rate, and they will not have a redistributive fiscal system to compensate. If economic agents do not learn to respond to shocks by changing wages and prices, and by shifting among jobs, the European economy is at risk of operating for a long time at high rates of unemployment. That will, however unjustly, undermine support for EMU--which makes it all the more important for European governments to pursue policies that will encourage factor and product market flexibility. It is also a case for not setting the initial target inflation rate in Europe at zero.

But there is another reason to believe that an economy that operates around an average rate of inflation of zero may face greater difficulties than one operating around a slightly higher rate, say 2 percent. If the expected rate of inflation is zero, then the expected real interest rate cannot go below zero. And there are times when it would be useful for the real interest rate to be negative.

I conclude that a target inflation rate of around 1-2 percent is about right. Taking account of likely errors in measures of price inflation that would mean 2-3 percent on measured inflation. (I talk here of the center of the range, not the range that would be considered in the context of a formal policy of inflation targeting.)

5. Specifying a target inflation rate is only the beginning of the discussion of monetary policy. For the most difficult monetary policy decisions are those about how quickly to attempt to return to target when, for whatever reason, the economy is not at the target rate. **These decisions involve the short-run tradeoff between inflation and output** This is the tradeoff that has to be faced in making all the most important central bank decisions. When the inflation rate is high, how fast should the central bank attempt to return to price stability? It could do it rapidly, at the cost of a big recession. Or it could move more slowly, as the Bundesbank did in 1991 and 1992. When inflation and output are low, how fast should interest rates be cut? The decision is made taking full account of the short-run tradeoff.

For reasons that one can understand, central bankers often try to deny there is a short-run tradeoff, or that they take it into account. The reason is clear: by claiming they do not affect output, they seek to avoid responsibility for the trade cycle, particularly for recessions, and hope to free themselves to deal purely with inflation. This is a mistake, one which in the long run will be destructive of public confidence in, and will reduce, the credibility of the central bank -- for the fact is that monetary policy has powerful short-run effects on output, and that it is irresponsible not to take them into account.

The Federal Reserve has no difficulty explaining its policies taking the short-run tradeoff into account, and there is no reason any other central bank cannot do the same.

This is not a trivial point: the ECB faces the challenge of establishing its credibility, and it will to this most durably if it faces up to even the inconvenient facts of life about the tradeoffs it is choosing.

6. Money versus inflation targeting The EMI in its January 1997 report The Single Monetary Policy in Stage Three: Specification of the Operational Framework identifies monetary targeting and direct inflation targeting as the two potential candidate strategies for the monetary policy of the ECB, and it leaves the choice, as it is required to, to the ECB.

It is not necessary in this company to rehearse the benefits of the two choices. But the case for serious monetary targeting is very hard to make at the best of times, and certainly at a time when the behavior of money demand is difficult to predict. Indeed, I believe the Bundesbank has gained credibility despite its announcements of money targets, rather than because of them. It has repeatedly had to explain why it cannot meet those targets, and there is by now no good reason to think it will meet those targets unless they happen to coincide with the goals it is actually pursuing -- primarily low inflation, but also the stabilization of output.

To gain credibility, the ECB will have to indicate what its inflation targets are; announcing money targets will not be sufficient. Whether it needs to move to a formal system of inflation targeting is another matter. I believe it should, by announcing that it intends on average to produce an inflation rate of about 2 percent, and that in its day-to-day operations it will target an inflation rate two years ahead of 2 percent--along the lines of the monetary policy strategy the Bank of England will be pursuing. The ECB may want to announce monetary targets as well, but there is little advantage in doing that.

It could be argued that it would be unwise to target a specific inflation rate until the ECB gains a better understanding of the monetary mechanism in Europe. That is not convincing: the ECB should announce the target, so that economic agents know what it is aiming to do. A target in the 2-3 percent range is close to current rates of inflation, and it is quite likely attainable. There is no reason to introduce extra uncertainty about the goals of policy by refraining from specifying an inflation target.

It will also be important for the ECB to seek the endorsement of the governments of EMU members for its inflation target. This will increase the credibility of the ECB's policies, and help deal with concerns over its democratic legitimacy.

7. There remains the question of how independent the ECB will be. There are two visions: one that the ECB will be the Bundesbank writ large; the other that the ECB will be the Bundesbank tamed. These visions are not consistent.

Which will it be? The Executive Board will consist of four-six members, the President and Vice-President of the ECB and two-four others "of recognized standing and professional experience in monetary or banking matters', to be appointed by Heads of State or Government, after consultation; the Governing Council will consist of the members of the Executive Board together with the governors of national central banks. It is the Governing Council which will formulate the monetary policy of the Community.

The structure is reminiscent of that of the Federal Reserve Board and the Open Market Committee. The appearance is that the Governing Council will be the more important decision-making body. But the history of the Federal Reserve System should remind us that it is difficult to predict where the power of the system will reside, and it is quite likely that it will gravitate to Frankfurt.

Either way, it is hard to see this central bank as being under the control of politicians. The memberships of the Executive Board and the Governing Council leave very little room for the appointment of politically pliable people. The design of the ECB has all the ingredients needed for independence, and provided it uses its powers well, the ECB will be independent. In its devotion to fighting inflation, the ECB will be the Bundesbank writ large.

But it is possible to do even better than that, for instance by giving up monetary targeting and adopting an explicit inflation target, and by acknowledging the short-run tradeoff between output and inflation.

In any event, it is important to emphasize that this will be a strong and independent central bank. It is sometimes said that we do not yet know whether the Euro will be a strong or a weak currency. The design of the ECB and its governing bodies leaves no doubt: the Euro will be a strong currency.

8. Finally, let me return to the question of the present uncertainties about EMU, about who will be in the beginning, whether to start on January 1 1999, how strictly to interpret the criteria, and so on.

Up to the time of decision, there is are good reasons to insist on the complete fulfilment of the convergence condition. The Maastricht convergence criteria have performed an important service in helping bring fiscal discipline to European countries. The convergence to central government deficits close to 3 percent of GDP is an achievement, even if it is regrettable that it was not possible to get to these deficit levels without the spur of Maastricht, and even if most countries need to go further yet in reducing deficits.

Nonetheless, when the time of decision comes, we need to accept that from an economic viewpoint, it makes very little difference whether the budget deficit is 3 percent or 3.5 percent. The only reason given for insisting on a rigorous interpretation of the Treaty is that to do less would reduce the credibility of the ECB. That is true. But it is also true that waiting longer will create uncertainty and confusion. It is important to get on with the business of starting EMU, and allowing the anti-inflationary monetary policy operated by an independent central bank to help--along with the stability pact--contain the fiscal deficits that have been so hard to control in Europe.

This is a unique historical juncture, and the decision on EMU is far too important to depend on a mere decimal point.

Thank you.