MONETARY POLICY IN A NEW ENVIRONMENT

Comments based on papers presented by
Otmar Issing and Robert T. Parry

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Being part of the Eurosystem, my views on important, strategic issues, like those we are discussing today, not surprisingly concur 100% with those expressed by Mr. Issing. I will try nevertheless to formulate some ideas to complement his presentation by focusing on certain elements of comparison with the Federal Reserve approach, presented today by Mr. Parry.

We have witnessed over a relatively short period an important process of global economic integration, fostered by remarkable progress in information technology and further advances in market deregulation. This higher degree of economic integration is paving the way for an improved and more efficient allocation of resources at an international level and, at the same time, is posing new challenges to policymakers. Monetary authorities are no exception. Thus, the new environment is, first, reducing the effective room for manoeuvre for national monetary policies. And second, it is rendering the framework in which monetary policies are carried out more complex and uncertain.

As the degree of global economic integration increases, the results of the monetary policy decisions made by central banks increasingly depend on how the international markets assess such decisions as well as on the monetary –and non-monetary– policy decisions made around the world. Of course, under normal circumstances the markets' growing monitoring of monetary policy decisions provides incentives that go in the right direction and penalise policy decisions inconsistent with the long-term monetary policy targets. Yet it is also known that, under some other circumstances, markets overreact to shocks.

To overcome the problems associated with the reduction in their room for manoeuvre, some central banks –generally those of relatively small and open economies– have replaced their internal targets by external ones, typically an exchange rate rule. This can hardly be the best choice for relatively large closed economies.

As we know from the old debate between rules and discretion, tying the central bank's hands is not desirable when monetary policy is implemented in a complex and uncertain environment. Yet higher global economic integration is increasing precisely the uncertainty and complexity of the framework in which monetary policy decisions have to be made.

Thus, globalisation is enlarging the geographic dimension of the set of variables that monetary policy makers have to monitor in their decision-making process. Moreover, financial innovation and sophistication, which are both cause and consequence of the globalisation process, are blurring the borders between money and other financial assets, are changing the relative weight of the different transmission channels and seem to be creating new monetary transmission channels that are not yet well understood.

In this framework, relatively large economies cannot forgo monetary flexibility. The challenge is how to retain such flexibility –thus overcoming the well-known dangers associated with monetary policy settings that are too rigid for a timely and efficient reaction to shocks– while at the same time avoiding the inflationary bias that might result. Mr. Parry´s presentation has highlighted very clearly how the Fed masterfully managed this trade off over the recent period, adapting monetary conditions in a forward-looking and flexible manner according to the prevailing assessment of risks. The excellent results of this strategy have reinforced the credibility of the Fed, thus providing, through a virtuous circle, additional leeway for the implementation of this type of flexible strategy.

Over the last twenty years a consensus has emerged about what monetary policy can and cannot do. As noted by Mr. Issing in his presentation, an overly discretionary strategy to stimulate growth beyond its potential level only leads to higher inflation without gains in terms of unemployment. By contrast, a central bank commitment to price stability over the medium term positively contributes to creating a framework of stability capable of fostering economic growth. This commitment, however, does not imply that the monetary authorities should ignore

the short-term impact of economic shocks. They have to deal with these shocks according to their impact on price stability.

This consensus is based upon the recognition that the effects of monetary policy have long and variable lags, upon general agreement on the absence of a long-run trade-off between inflation and unemployment and upon the growing importance of private-sector expectations. Moreover, a large amount of new evidence tends to confirm that macroeconomic stability promotes a more efficient functioning of the economic system, thus raising living standards.

These elements have helped to transcend the old fashioned rules-versus-discretion debate, which has been replaced by a broad agreement on the general principles that should guide the design of monetary policy in the new environment. These principles can be articulated in two levels.

At a first level central banks should be endowed with an institutional framework firmly founded on four basic elements: a commitment to price stability as their primary goal; independence from political pressures, in general, and from government bodies, in particular; a high degree of accountability as an ingredient of their heightened independence; and finally, and closely related to the previous element, transparency of the monetary policy strategy.

At a second level, the monetary policy strategy should be one of "bounded discretion" based on five elements. First, achieving the proper balance between, on the one hand, long-run discipline consistent with price stability and on the other hand, short-run flexibility to deal with unanticipated shocks. Second, conducting monetary policy in a forward-looking and pre-emptive fashion to take account of the long and variable lags with which it impacts the economy. Third, basing policy decisions on a wide range of indicators, which have to be interpreted judgementally. Fourth, choosing a strategy that is sufficiently robust to the uncertainty regarding the nature of shocks and the workings of the transmission mechanisms, as to guarantee the achievement of its goals. And finally, to complement these four elements relating to the internal decision-making process, an intensive effort to

establish a clear communication policy capable of transmitting to the public in an efficient and timely manner the rationale behind the decisions taken.

It is worth noting that, from a practical point of view, these general principles are currently present in the design of the monetary policy implemented by both the Federal Reserve System and the European Central Bank. Yet, as shown by the presentations of Messrs. Issing and Parry, there are some significant differences.

The Federal Reserve System has an important historical track record behind its actions, which has over time built an anti-inflationary reputation. The European Central Bank, by contrast, is a newly created institution that lacks previous experience in conducting monetary policy at the euro area level. In most countries, monetary policy is to a large extent based on past experience. Central banks learn from past mistakes. The interaction with the markets and the economic agents at large –which is vital for its credibility–is founded on a learning process in which the past record of actions, decisions and communication policy play a major role. The ECB, although inheriting in part the track record and reputation of some of the most successful central banks, needs to forge its own channels and its own ways to firmly establish its reputation. This process inevitably requires some time.

Another difference between the conduct of monetary policy by the Fed and the ECB is the multicountry nature of the euro area. As compared to the US, the existence of various sovereign states in the euro area complicates the monetary policy strategy. Not only does the euro area lack political cohesion, but it is also characterised by less than full economic integration. Without doubt, the single market is a major achievement of the EU and its results are impressive when compared to the situation a few decades ago, but this is necessarily a slow process and elements of segmentation inevitably remain, which will take some time to remove. More importantly, economic policies other than monetary policy are decentralised in the euro area, and this entails a challenge for monetary policy in several respects. Two areas deserve particular attention in this regard, due to their close connection with monetary policy: fiscal policies and wage-setting procedures.

It is true that fiscal policies are constrained by the Growth and Stability Pact, an element of EMU which was not foreseen when the Maastricht Treaty was drafted, but incorporated a few years later. Important as the Pact is, it is however limited to a set of rules constraining undisciplined fiscal policies, and is not a genuine co-ordination device.

Concerning wage-setting procedures, there is a wide variety of models in the euro area, with different degrees of centralisation, entailing different ways of reacting to shocks. Certain differences may and must coexist in a monetary union, provided that there are mechanisms to ensure that wage rises match productivity gains in each country, region, sector or company. Yet this is far from clear in the European case.

All in all, the economies of the euro area are still different not only in their evolution and their exposure to shocks but also in their structures and in the way they are willing to react to some shocks. This increases the difficulty for the single monetary authority of obtaining a clear picture of overall economic developments in the area and additionally complicates the task of understanding and forecasting how the aggregated transmission mechanism works. Moreover, these differences in structures and transmission channels imply that not only do the indicators and results for the area as a whole matter, but so does their dispersion across countries. These problems associated with the multicountry nature of the area are further exacerbated in the short-run by the lack of a set of area-wide statistics of a sufficient quality. Although substantial progress has been made in harmonising and defining euro area-wide statistics, there is still a high degree of heterogeneity in some items and there are also important deficiencies in others. These difficulties are to a certain extent being overcome by the interaction between the different components of the Eurosystem, whose federal structure is well adapted to this situation. As mentioned by Mr. Issing, the national central banks play an important role in the process of gathering and analysing information, particularly in that concerning the production of the ECB macroeconomic forecasts.

In this complex framework, it is hardly surprising that in the period since the inception of monetary union the external communication policy has proved to be one of the most difficult tasks of the ECB. Yet, the progress made in this regard has been remarkable, and little by little the ECB is making itself increasingly clear to the markets and to the public. It is important to persist with these efforts and to improve communication channels. In particular, the perception by economic agents of a single message and an homogeneous language among Eurosystem components as concerns monetary policy strategy and decisions is vital to underpin credibility. This unity of expression is an essential component of the single monetary policy, and does not exempt NCBs from the task of explaining the implications for the national economies of decisions taken at the euro area level. National central banks should be the voice of the Eurosystem as concerns the specific situation and problems of each national economy.

I would not like to finish without referring to an additional complication for monetary policy, that is quite unique to the case of the euro area: the prospects of enlargement due to the participation of "out" countries or, from a longer-term perspective, of future EU entrants. Enlargement will in the long term be positive for the European project and will reinforce the stability of the area, but the complexities that this prospect entails –for the EU in general and for monetary policy in particular– require reforms to the institutional setting. The extent to which the process of enlargement and reform is carried out in a consistent and appropriate manner is a factor that will probably also have a significant impact on monetary policy credibility.

Closely related to this process is the issue of greater political cohesion within the EU. At the time of the discussions that led to the Maastricht Treaty two intergovernmental conferences were set up, one on political union and another on economic and monetary union. As is well known, progress on the latter went much farther than on the former. Without entering into the complex debate on the institutional model for the EU, I think that accompanying economic and monetary union with a strengthening of the political cohesion of the EU would have a favourable impact on monetary policy credibility and effectiveness.

Monetary policy is partly an art partly a science. Either way, for an area with the complexity of the euro zone, it is neither an easy art nor an easy science.