

Overview: Central Bank Perspectives

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First I would like to join others in expressing my thanks to the Federal Reserve Bank of Kansas City and its president, Roger Guffey, and to Tom Davis for inviting me to this symposium that takes place in such an exciting environment here in Jackson Hole. I am especially pleased to be here because participation in this symposium is one of the last activities in my professional life as a central banker. After having served for more than 25 years as a member of the Bundesbank's Central Bank Council, I shall retire at the end of this month. But, of course, I will continue to take a close interest in monetary policy issues; even though I will no longer take an active part in policymaking in the 1990s.

One of the main issues for the 1990s is the evolution of the European Economic Community toward an Economic and Monetary Union. Governor Leigh-Pemberton, in his luncheon address of yesterday, dealt with the implications for monetary policy of "Europe 1992." I was tempted to add a few remarks on this issue from the point of view of a central bank whose economy and currency, the deutsche mark, have grown into a role that has, somewhat critically, sometimes been called dominant but, more positively, has served and continues to serve as a stability anchor for the European Monetary System. During the transition period, before the full implementation of economic and monetary union, monetary policy will continue to be conducted under national responsibility, but more and more in an environment which is characterized by full freedom of capital movements and increasing integration of financial markets. For the

monetary policy of the Bundesbank this will be, of course, a very important issue in the 1990s. But my time is too short to deal with this question here, so I resist this temptation.

Instead, I will concentrate my remarks on two points. The first one concerns the role of monetary aggregates as an intermediate formal target or as a guide for the conduct of monetary policy. Charles Freedman makes some very interesting points on this issue in his paper.

The second issue concerns the likely development of the international monetary system into a tri-polar currency system and the implications such a change might have for exchange rate and monetary policy. In his paper, Yoshio **Suzuki** predicts that such a tri-polar system will be in place by the mid-1990s.

Let me begin with the issue of monetary targeting. It has always been a strong conviction in the Bundesbank and its predecessor (the so-called Bank **Deutscher** Lander which was established in 1948 under American influence), that the primary goal for a central bank is price stability. I have nothing to add to what Charles Freedman has said in formulating convincing arguments in favor of such a strict definition of the central bank's task. It is the primary role of central banks to look after the stability of domestic prices. As one important achievement of the EMS, all participating central banks have now endorsed this principle. Officially, it was first expressed in 1987 in the so-called Basle-Nyborg report of EEC Governors on the functioning of the EMS and recently repeated in a draft decision to be adopted by the EEC Council of Ministers which the governors were asked to formulate. This decision will extend and strengthen the role and responsibilities of the Committee of Governors of EEC central banks in the first stage of the Economic and Monetary Union. This Committee of Governors will likely develop in the 1990s into something that can be called a European Federal Reserve Board or a European Central Bank Council.

Monetary targeting can be very helpful in achieving the final goal of domestic price stability. For myself, I was never as strongly convinced as many monetarists are, of a close relationship between the monetary aggregates and the real economy. Under most circumstances it will be a useful concept. But, in some circumstances, strict adherence to an aggregate without further analysis as an indicator for policy can lead one to wrong conclusions.

In the political and socioeconomical environment in which central banks have to act, a monetary policy based on an aggregate as an intermediate target can facilitate the task of convincing politicians and the general public of the appropriateness of a policy that otherwise could provoke strong opposition. That will be the case, in particular, when a central bank, in order to fight inflation or to prevent inflationary forces from spreading to all sectors of the economy, has to embark on a restrictive path, necessarily accompanied by high interest rates. In the early 1970s, when inflation rates in Germany during the last stage of the Bretton Woods System reached unprecedented levels, the Bundesbank came under severe pressure to demonstrate its ability and firm determination to pursue a non-accommodating monetary policy in order to break the domestic inflation spiral. This was the dominant political consideration which led to the adoption of a formal monetary targeting framework in Germany in the mid-1970s.

In the given German context, this strategy was designed to give private and public decisionmakers clear guidance about the general stance of monetary policy and give them a monetary framework for nominal spending and price and wage setting. The ultimate aim was to facilitate agreement among the social groups, minimize friction between the various areas of economic policy, and reduce the potential output and employment costs of inflation control.

Although target-guided policies could not always be implemented without friction and, for a number of years, we had to accept strong deviations from our annual targets, the Bundesbank has adhered to this practice up to now. Monetary targeting proved to be particularly useful in breaking inflation spirals after the first and second oil price hikes in 1974 and 1979 and after the deutsche mark's "depreciation crisis" in the early 1980s. Since then, a supply-side orientation of economic policy, the budget consolidation course pursued by the federal government, moderate wage settlements, and the temporary market falls in world energy and raw material prices have greatly facilitated the Bundesbank's task. In 1988, inflation was down to a record low of less than 1 percent. The Bundesbank feels that adherence to monetary targets may be a good method of consolidating this disinflation process, even though it has proved especially difficult in the last few years to reconcile domestic monetary targeting with the requirements of exchange rate management.

The reason why a target-based monetary policy has been repeatedly confronted with difficulties in the case of Germany is not so much because of deregulation in the financial markets, as has been the case in other countries. Interest rate regulations were abolished more than 20 years ago and monetary policy in Germany has been conducted on the basis of market oriented instruments. Deregulation has had only a limited effect on the aggregates. But, as a medium-sized country which is the biggest exporter in the world economy and which, since the second half of the 1950s, has had practically no restrictions on capital movements, external factors are playing an important role with far-reaching implications for the monetary aggregates. With the globalization of international financial markets and the growing role of the deutsche mark as a reserve and investment currency, these influences have become even more important. Repeatedly, German monetary policy has been confronted with the problem of reconciling its target-oriented policy with the need to avoid, as far as possible, a misalignment of the exchange rate of the deutsche mark, without endangering the achievement of the final goal of its policy which is domestic price stability. The development of the aggregates has not always been a reliable guide in deciding about the appropriate direction of monetary policy.

I will give just one example: in 1986 and 1987, non-banks in Germany recorded a huge inflow of foreign exchange via a growing current account surplus, accentuated by strong inflows of short and long-term capital. Accordingly, we saw a strong overshooting of monetary targets. After thorough analysis, we came to the conclusion that to tolerate this overshooting was better than to react to it with a monetarist answer of further tightening monetary conditions. The main cause of this overshooting was not, as happened quite often in the 1960s and 1970s, an export induced surplus in a worldwide expansionary and sometimes inflationary environment, but an import price-induced surplus in a world economy characterized by uncertainties and moderate growth rates. In Germany, this overshooting took place at a time of a strong appreciation of the deutsche mark with welcome stability effects on the one side, but contributing to the uncertainties in the business community on the other side. At the same time, growing real imports, welcomed in the framework of the adjustment process, were a cause for low domestic real growth rates.

Let me add another scenario. In Germany now, we are close to

our monetary target for **1989**. There seems to be, from this point of view, no need for a further tightening of monetary policy. The high liquidity preference of German investors, which was one of the reasons for overshooting in previous months, has normalized after the announcement that the plan to introduce a withholding tax on interest rates has been abolished. But, at the same time, the huge net capital outflow which had its cause, in large part, in withholding **tax** considerations, has been reversed into a capital inflow to the non-banking sector of the economy. **An** even larger current account surplus than last year, combined with a capital inflow to non-banks, could easily lead again to a similar overshooting of aggregates as was the case from **1986** to **1988**. But this time, the causes and the environment are both totally different. The growth in the current account surplus is, to a large extent, export induced. In addition, we are living in a world economy with strong real growth in a number of industrial countries, mainly in Europe, some of which are experiencing inflationary pressures, and with a domestic economy that is fully employing all its physical capacities and a deutsche mark, that has been, for some time, more on the weak side. Under those conditions, a new overshooting could not get the same answer as a few years ago and monetary policy would have to react. To avoid misunderstanding, I **am** not saying that such a scenario will become a reality. My intention is only to demonstrate that the development of the money supply, in light of the complex interrelationship between monetary aggregates and the real economy, needs a careful interpretation and analysis of the causes behind the growth of the monetary aggregates. Monetary policymakers must examine whether the factors contributing to monetary growth reflect inflationary forces at home and whether an ample money supply, even if caused by noninflationary factors, in a certain environment could induce inflationary dangers. The concept of a policy based on monetary targeting is not as simple as it seems to be to a number of monetarists.

I have much sympathy with the view of Charles Freedman when he says that it is most useful to think of financial aggregates, both money and credit, as playing the role of policy guides, rather than that of formal targets for the next few years. But I also agree with him that the distinction between these two concepts—policy guide and formal target—is one of degree rather **than** substance. In its policy, the Bundesbank has proved to be flexible. In the context of its

monetary policy, the Bundesbank repeatedly has also taken into account other factors, especially external influences, and has accepted an overshooting of its monetary target when justifiable.

But we do see, also, the danger for a central bank in using a formal target. It could become confronted with a loss of confidence in the chosen aggregate, and even more, a loss of its own credibility if it appears not to be able and willing to achieve the announced target growth rate for the **chosen aggregate** on most occasions. Frequent or continued overshooting or undershooting can, indeed, pose a credibility problem. But we believe that this risk may be controlled as long as the final objective, price stability, is achieved. In Germany, this has been the case over all the years since 1986, when we accepted and tolerated the overshooting. At any rate, the Bundesbank has always endeavored to give a convincing justification to the public as to why it would not have been appropriate to try to attain a specific monetary target at any cost. This, too, may have contributed to the maintenance of its credibility.

Charles Freedman makes another remark in his paper in the context of monetary targeting which brings me to my second point: namely, the implications for monetary policy of an emerging tri-polar international monetary system. As one of the conditions under which an aggregate could be used as a formal target for monetary policy, Freedman mentions a stable relationship between the monetary aggregate and the target variable, either nominal spending or prices. The example of Germany shows that countries that are strongly integrated into the world economy may have a more complex inter-relationship between the development of their money supply and the real economy than countries where—like the United States—the domestic economy, because of its size, is much less influenced by external factors. In the case of Germany, the export of goods and services counts for one-third of GNP. The figure for Japan is not even half this size, and for the United States, this figure is still, even after a strong increase over the last two decades, below 10 percent. Imbalances in the combined account of current transactions and capital movements of non-banks, one of the determining factors for monetary aggregates besides domestic credit expansion and domestic monetary capital formation, have often been quite large in Germany, while they compensate each other much more in Japan and the United States. Under those conditions, monetary targeting is confronted with very

difficult problems. Small countries in Europe, normally with an even higher share of foreign trade in their GNP, have, therefore, refrained from the targeting of monetary aggregates. They pursue an exchange rate oriented policy and, in a number of cases, have tied their exchange rates to those of their most important trading partners since they are satisfied with the results of the economic policies of these partners, **mainly** in terms of price stability.

Surely, the United States as **well** has had some problems as far as the money supply as a monetary target was concerned. But these problems had more to do with the effects of financial deregulation than with external factors and they were, I suppose, more of a transitional nature. I agree with Lyle **Gramley** and others, that the innovation process will probably continue in the future and influence the money supply. But I believe that innovation will develop more smoothly than in the past and not in such an erratic way as in the early **1980s**, so that a target oriented monetary policy will be able to cope with it better than at some time in the past. I have noted also the point made by Lyle **Gramley** and by some others in the discussion, that the external factors will also be playing a larger role for the United States in the conduct of monetary policy than in the past. But still, compared to GNP, the external factors will remain relatively small and the impact on monetary aggregates, as well as on the real economy, will remain much smaller than is the case for most medium and small-sized economies in Europe.

Normally, there will, I suppose, continue to exist a more stable relationship in the United States between the monetary aggregates and the real economy than in economies of a smaller size. Perhaps it is no accident that monetarism as a theoretical concept was invented in the United States, after Milton **Friedman** and Anna **Schwartz** had written their famous book on American monetary history.

One consequence of regional integration into a single market of a big size will be a substantial reduction of the foreign sector for this now bigger economy, compared to the sometimes extremely high proportion for individual member economies. This will be the case in Europe, where interregional trade is playing a very important role. Such a development will presumably create better conditions for a monetary policy that is based on aggregate targets. But the implementation of such a monetary policy for the whole area will become feasible only after a common monetary authority has been established.

This is a political aim for Europe, but we are still far away from this and I doubt whether this will ever happen in the Pacific area. Anyway, I do not believe it will be an issue in the 1990s, at least not in the terms I just described.

But I can imagine that, in a continuing process of integration, monetary coherence within these areas **will** increase with one or more countries of sufficient size pursuing a policy with the aim of forming a core of monetary stability, thus providing the whole system with an anchor resulting in relative exchange rate stability within each area. One of the challenges of the world in the 1990s will be, as Yoshio **Suzuki** outlines in his paper, how to make the "domestic" stability in each currency area compatible with the stability of exchange rates among these three areas while maintaining free trade and free capital movements in the world under the free floating exchange rate system. I agree with Yoshio Suzuki that, on the domestic front, tri-polar countries should conduct monetary policies which emphasize money growth as the intermediate target and give top priority to domestic price stability. This would, **indeed**, limit the scope for influencing foreign exchange rates in the shortterm through interventions and manipulation of interest rate differentials.

However, large currency areas may enjoy less external constraints for their real economy than individual countries under the present system, and exchange rate movements among big currency blocs may become, if they appear, more tolerable than under present conditions. The impact of exchange rate movements on these large "domestic" markets would be much smaller than today for a number of medium and small-sized economies. This does not mean pleading for a policy of "benign neglect" as to the exchange rates of these currency blocs. But as the United States with its repeated policy of "benign neglect" in the past has shown, at least to some degree and for a certain time, a large domestic market can absorb the impact of exchange rate movements better than economies with a relatively large foreign sector.

However, this does not mean that there would no longer be a need for close cooperation among these currency blocs. Governor **Leigh-Pemberton** has rightly pointed out that such a cooperation would remain necessary and it should be based on the priority goal of price stability. But even a close cooperation will not always exclude the possibility of capital flows causing exchange rate movements that

influence the real economies. Therefore, there remains a need for some elasticity of exchange rates between those currency areas. But because of their size, they would be in a better position to cope with such exchange rate movements now than would smaller economies.