

## The Role of the Central Bank in Achieving Price Stability: An International Perspective

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For Europe, the United States is the dominant economy in international trade, today more so again than in the decade of relatively high inflation in the U.S. At the same time, American economists have gone to the front of international economic theory, a lead that we admire greatly, even if at times with some skepticism.

As a central bank practitioner from a European country, and given what I have just said, there is a particular challenge for me in dealing from an international perspective with the subject of this symposium in a luncheon address. It is not only the topic that is the challenge, it is the luncheon too, and I am sure my speech is only going to be able to spoil its high quality. What I am able to say on the topic of price stability is of necessity colored by the experience of central bank policy and practice in my own country and certainly cannot serve to attempt generally valid answers to questions that are the subject of academic controversy. What I want to do on this occasion might be seen as a modest attempt to describe for you in a type of shortened *tour d'horizon* what ideas have been taking shape in my country's central bank on some of this conference's main topics.

This morning, great academic seriousness has been used to treat the questions of the causes of inflation and the cost/benefit analysis of price stabilization policy. In recent times, economic theory has again been concerning itself more strongly with these questions. A short time ago, they were dealt with in a seminar of European professors at the Bundesbank, too. These subjects constitute a continuous challenge for every central bank practitioner. Many inflation theorists tend to reproach monetary policymakers for pursuing ambitious stability policy goals "at any price." I do not want to deny the fact that the Deutsche Bundesbank is to be counted among those central banks that have always given the economic policy

goal of price stability priority in their considerations. In fact, right from the beginning, the Bundesbank understood its role to include defending the goal of price stability against all comers and actively popularizing this goal by the spoken word and in print.

The Bundesbank has a style of argument in public that, *inter alia*, would agree with the comment of one of its own presidents: In the long run, an economy cannot have 'just a little inflation: for if you start flirting with inflation, it will end up marrying you' (Emminger). So we in the Bundesbank never seriously entertained the previously popular idea that a certain amount of creeping inflation was helpful or necessary for steady economic growth. In the same way, the Bundesbank has always been publicly against the idea of making life under inflation easier, as indexation advocates say it would be, by indexing taxes, interest rates, and wages and goods contracts. In doing this, the Bundesbank never overlooked the fact that in the course of the '70s, inflation was fed by internal and external disturbances that did not fit traditional notions of pure demand-pull inflation.

Foreign observers—and among them not least economic theorists—have probably been asking themselves from time to time how Bundesbank spokesmen can justify their confidence when spreading the gospel of price stability both at home and abroad. One frequently quoted opinion amounts to saying that the cause can be found in the traumatic consequences of two war- and government-induced inflations in Germany, or even in an inborn German tendency to conservatism and dogmatism. Now, nobody would deny that the German historical experience of inflation has been influential in determining the attitudes of our population and politicians since World War II. This fact is of no minor importance in explaining why the Deutsche Bundesbank, in the statute determining its position and activities, was required to pursue the primary goal of price stability. In addition, the Bundesbank's authority with respect to monetary policy was made independent of the government and Parliament.

However, it would be going too far to link recent attitudes at the Bundesbank only to this negative experience of inflation. The other side of the coin should really be mentioned here as well, namely that in our country, economic revival has twice been associated with the creation of new and healthy money—in 1924 and in the middle of 1948. You may object that this is all a long time ago, that today's problems have more nuances. And in fact, you would be right. But the last 10 to 15 years have seen a confirmation of the fact that practically all countries that have tried to get along with a little bit of inflation, or indexation, have run their stability policies onto the rocks.

This does not refute at a theoretical level the academic usefulness of **cost/benefit** thinking in inflation theory, or of contract-based indexation concepts. However, it seems to me that the global experience of inflation since the start of the '70s can be equated with a field trial in society at large, from which monetary policy can learn at least a few provisional lessons.

This experiment has shown that it is difficult indeed to steady inflationary processes once they have gotten under way, that it is not possible to adjust the economic policy autopilot to an annual rate of 5 or 10 percent, and then hope that the autopilot will stick to it. Firstly, this can be traced back to the disappearance of the illusion of money and the dynamics of inflationary expectations. The theories of adaptive and rational expectations have proceeded from this state of affairs. At the same time an inflationary climate—at least in Europe—appears to favor militant distribution conflicts. The competing claims that crop up here of the different groups in society can easily develop a home-made inflationary spiral. A spiral of this sort can easily start its ascent under an accommodating monetary policy, and for certain weak currencies, it can in certain circumstances be aggravated by the vicious-circle phenomenon induced by depreciation.

High inflation rates that fluctuate and are therefore hard to predict hamper the signalling and allocation function of relative prices and thus also the growth process, and these facts are pretty well universally accepted today. At the same time, experience in high-inflation countries suggests that their populations perceive an uncontrolled ongoing inflation as a deterioration in their quality of life, especially as to date there has been almost no success anywhere in indexing taxes, social transfers, and interest and wage income on a distributionally neutral basis. On the contrary: inflation always brings about a change in income distribution, and in the final analysis in property distribution too, and usually this is negative rather than positive for the economy. This experience of frustration has had global consequences.

Until the beginning of the '70s, the stability policies of a minority of major central banks, for example those of the Federal Republic of Germany, Switzerland, and at times Japan, too, tended to be classified as dogmatic. But after the outbreak of the second oil crisis (1979-80) at the latest, these policies were largely being imitated at the international level, as the most important central banks jointly tried to get a fresh grip on inflation, which was accelerating worldwide. Some countries, e.g. the United Kingdom and the United States, applied a particularly strong grip to throttle

the steep rise in their inflation rates down to a more tolerable level, and, without doubt, doing this meant at times taking on high-level risks with respect to employment. In general, the impression was created that countries of this type, which appeared to have lost control over inflation, had to apply monetary cold-turkey methods in the end so as to influence price expectations into dropping in a sustained fashion. In Germany, we have actually only taken this course once—after the outbreak of the first oil crisis (1974-75) after German monetary policy had temporarily lost credibility—due to ongoing and massive inflows of funds from abroad. Later on, Bundesbank policy did indeed display certain gradualistic traits, after trust in the Bundesbank's perseverance seemed to have been restored. In the still unsettled academic controversy as to whether it is rigorous or step-wise methods of inflation-fighting that promise more success, the Bundesbank has thus adopted a pragmatic attitude: It relates what it does to the initial conditions and the climate of expectations in which its monetary policy has to be applied. I have great difficulty in seeing how any other course could possibly be taken.

This attitude also has to do with the fact that we are aware our influence has its limits and that we must not forget where they lie. Naturally, we acknowledge the widely accepted academic view that in the longer term, inflation must always be understood as a monetary phenomenon. To this extent, no central bank can evade ultimate responsibility for keeping a check on price trends. In spite of the opinion that Germany was and is more or less an island of stability, our own experience is not the least of teachers in pointing out to us the limits that obtain for monetary stabilization policy in the shorter term. This observation of mine may surprise some of you, who as professional or academic Bundesbank watchers keep track of our statements and measures from time to time. So without wanting to anticipate later conference topics, let me say a few words about the way in which we are trying to do justice to the hindrances and limits to monetary policy that we recognize when pursuing the practical implementation of our price stability goals. Those foreign observers who have been occupying themselves in some detail since the middle of the '70s with the Bundesbank's monetary policy have sometimes noted with astonishment that the Bundesbank has seemed relatively generous when setting its annual monetary growth targets. Year for year, the Bundesbank derives its monetary growth target from two basic components: assumed growth in production potential and so-called 'unavoidable' price rise. Thus, we have always cut the monetary cloak with sufficient generosity for it to allow enough room for appropriate economic growth. But on the other hand, we

have also assumed an unavoidable price rise. This has always been 0.5 to 1 percentage point below the relevant inflation forecasts, which have never been very high. And we have also expressed the belief that there can be no go and then stop in price movements, but only a gradual reduction of inflation. In this way, price goals have been formulated over the years that were usually noticeably above an inflation rate of 1 to 2 percent, a price rise that today we would characterize as a satisfactory approach to price stability.

This policy has fairly often given rise to reproaches: For example, that the Bundesbank likes talking about stability but isn't aiming for it. In actual fact, the only realistic assumption is that price rises that already appear to have worked through into business planning cannot be stopped at once. At the same time, our policy has given us a chance of reacting moderately to external price shocks—such as oil price increases and import price jumps determined by exchange rates. In doing this we have largely been concerned to avoid transplanting exogenous price disturbances via domestic adjustment inflation, without avoiding at any cost the direct effects of terms-of-trade deterioration on the domestic price level. A strategy of this type naturally presupposes a certain public trust in the course of central bank policy, and I have to admit here that prices and wages have by no means always reacted in an ideal fashion to the monetary framework set by the Bundesbank. *So* I am sure that in some cases we were tending to be too soft rather than too hard. We did indeed consider the probable costs of fighting inflation from a short-term point of view—that is, the short-term effects on production and employment. A further peculiarity of our stability policy strategy is that we do not formulate our price stabilization goals behind closed doors. Although the Bundesbank has statutory protection against direct attempts at political interference, it tries very consciously to obtain a certain degree of advance backup from other economic policy authorities and prominent groups in the community. This way of proceeding rests on the conviction that a monetary policy geared to stabilizing the price level can get satisfactory results in the long term only if the central bank's efforts are clearly recognized by all economic actors and receive their support. For some of those involved in economic activity, a monetary growth target may, however, appear to be a relatively abstract quantity that has no direct effect on the way they behave. Others could at least pretend that they do not properly understand the Bundesbank's intentions. But we also associate with our monetary growth target an unmistakable appeal to enterprises and unions to play their part, by behaving moderately in the process of price and wage formation, in allowing the real scope for growth in our economy to be exploited as far as possible without

endangering the postulate of stability. What is just as important in our policy is the constant attempt to base monetary, fiscal, and general economic policy on compatible benchmarks of stability policy. In this field, a well-established ritual has developed in Germany, and it serves to coordinate the various policy areas in a manner that the German public can recognize. In joint consultation with the federal government, the Bundesbank ensures that the price and growth conceptions of the Bundesbank and the federal government do not conflict. To date, this has always led to the government agreeing to the monetary growth targets announced by the Bundesbank.

Now, what have been the results of our stability policy? In view of the multitude of external disturbances and internal inflationary stumbling blocks that have hindered our policy since the beginning of the '70s, we are by now more or less content with the longer-term price performance of the German economy. Since the middle of the '70s, the inflation rate, measured by annual changes in the GNP deflator, has been moving without overly strong fluctuations on an underlying trend of between 3.5 and 4.5 percent, and of late has been tending towards 2.5 percent and lower. At the same time, however, even if for other reasons, real economic growth has weakened in the medium term. Moreover, we are now having to live with a level of more than 2 million unemployed, which can probably be cut back only step by step.

Nevertheless, I would not be prepared to see, in this unfavorable development on the real side of the economy, economic inflation-fighting costs that would be to the discredit of the Bundesbank's monetary policy. There are of course many deep-rooted factors that have caused a sustained weakening of economic growth from the supply side in many European countries—including the Federal Republic of Germany.<sup>1</sup> So we have to resist the temptation to oppose underemployment with easy and cheap money and higher government deficits. In this respect, the business situation we are faced with in Europe does not seem to be as favorable as it is in your case in the United States.

On our side of the Atlantic, we will have to pursue medium-term price stabilization goals against the background of a certain Euro-pessimism, but **this pessimism** should not be exaggerated. At least in the field of fighting inflation, there is a 'two-speed Europe': to use Mitterand's expression in another context. All around Germany there are countries

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1. See for instance: Bela Balassa, *The Economic Consequences of Social Policies in the Industrial Countries*, Bernhard Harms Lecture, Kiel, June 23, 1984, *Weltwirtschaftliches Archiv*, Vol. CXX, p. 213-27.

with similar levels of price stability: Switzerland, Austria, and the Netherlands. Moreover, the United Kingdom, Denmark, and Belgium are getting noticeably closer to this trend. Efforts being made in France are also considerable, even if not so successful. The monetary policy position in this respect is a varied one; for example, monetary policy is applied with more vehemence in the United Kingdom than in some of the other countries I have mentioned. The other speed is that of the Mediterranean countries; hopes of being able to make progress here are not so high.

In the United States, monetary policy is confronted with the all-too-familiar problem of enabling a soft landing for a vital and rapidly expanding economy after a strong upswing. The fact that monetary and fiscal policymakers do not at all times appear to be seeing eye-to-eye in this regard will not facilitate solutions to your stabilization problems in America.

But I did not come here to sing you some well-known tunes from a European lament. I hope, on the contrary, that on the basis of the joint efforts of American economic theorists and those responsible in office for public policy, the American economy will soon have shot the rapids and arrived at steady growth and relatively stable prices. I think this is not impossible. If we look out of the window here at the Grand Tetons, we might think them impossible to climb, and for most of us this is true. But let me tell you a story that one of my old mountaineering friends told me: A mountain looks invincible only from a distance. When you get close to it you can see tracks up it and even foot and hand holds that you didn't expect before. In other words, there is absolutely no reason to lose courage. I am sure that the intellectual effort put into this symposium will lend its strength to this happening. *So* in this sense I wish the organizers continued and complete success and would like to thank you all very much for listening so patiently to a central bank practitioner from the Old World.