

# **Challenges for Monetary Policy**

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## 1. Challenges in times of crisis

The financial crisis which started in 2007 has caused a tremendous challenge for monetary policy. The simple concept of inflation targeting has lost its position as state of the art. Central banks are called upon to focus monetary policy on fighting unemployment and tolerating temporarily somewhat higher inflation. This has triggered the question whether the mandate of a central bank should not be widened, especially in case employment and/or economic growth are not (yet) included in the present institutional arrangement. At the same time a comparable discussion has started on the responsibility of central banks to ensure financial stability. International cooperation or rather coordination in the sphere of monetary policy has also become an issue. In this context the status of independence of the central bank has been challenged.

Monetary policy has been very accommodative in the last couple of years. When interest rates reached the lower bound, central banks started to adopt measures of quantitative easing that last until today. In the context of measures of quantitative easing, i.e. buying heavily government (and other) bonds, the question of the border between monetary policy and fiscal policy has been raised. This is especially relevant for the ECB's purchases of bonds of countries in trouble.

While interest rates are historically low and liquidity is ample growth continues to be weak. To counter the economic inertia, central banks have modified their communication strategy by introducing forward guidance as a new policy tool. This has triggered a general debate regarding the adequate level of transparency in monetary policy.

This is not the occasion to deliver a thorough discussion of these important issues.<sup>1</sup> So, I will concentrate on the main aspects.

## 2. The zero bound and forward guidance

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<sup>1</sup> See Issing, Otmar, A new Paradigm for Monetary Policy, CFS Working Paper, 2013/02

Central banks have reacted to the crisis manifold with ad hoc measures. The risk of time inconsistency gives a strong warning that pure discretion will lead to uncertainty and volatility. One attempt to overcome this situation and to anchor expectations is by the use of forward guidance as a policy tool. Bernanke (Jackson Hole, 2012) has explained that this “is not an unconditional promise”, but rather, “a statement about the FOMC’s collective judgment regarding the path of policy that is likely to prove appropriate, given the Committee’s objectives and its outlook for the economy.” As such it is a self-evident statement and therefore meaningless. The Fed went first for a date-based forward guidance (mentioning late 2014 and later mid-2015 as a period of unchanged low interest rates) and then moved to an outcome-based forward guidance tying changes in the interest rates to targets for unemployment (6½ per cent) and inflation.

On 7 August 2013 the new governor of the BoE announced an explicit state-contingent forward guidance. In addition, the BoE published a document of 44 pages on “Monetary policy trade-offs and forward guidance”.

However, the fundamental problem of this “new policy” lies in the approach itself. Forward guidance suffers from the same sort of time inconsistency it intends to remedy. Saying that the policy rate is likely to remain low well into the future does not imply that the central bank, from the perspective of a future date and in the face of rising inflation, will have the incentive to follow through on its commitment. The reason being that at this moment in the future it will be confronted with all the costs associated with keeping the promise while the benefits will have been reaped in the past.

The credibility of the forward guidance approach suffers severely from the fact that communication of the horizon for forward guidance by the Fed has already changed several times. However, this risk is immanent to this approach. And the combination of low interest rates and quantitative easing makes it almost impossible to assess the monetary policy stance adequately. This applies even more for future policy changes.

Over such an extended period of time it is extremely difficult to forecast the impact of the announced monetary policy on the economy. New shocks might hit the economy. The time dimension of those developments varies with the type and

magnitude of shocks, the prevailing financial sentiment, the international environment and many other variables. Is it therefore not impossible to set the horizon for monetary policy in advance? Credible forward guidance, and thereby the anchoring of public expectations, cannot come from announcing a fixed number for a policy rate but from providing a strategy which allows the public a kind of ex-ante understanding of policy decisions under varying conditions by the central bank.

Announcing a specific number for the policy instrument, the main interest rate, for an extended period of time might be seen as an unconditional commitment, which carries the risk that any change will be interpreted as a surprise, with the potential to cause turbulence in markets and hurt the credibility of the central bank. On the other hand, "conditionality" of such an announcement might in the end give no forward guidance at all. There is even the risk that a kind of implicit pessimism about future growth might have an adverse effect.

A central bank which has adopted a convincing strategy and communicates the reasons for its policy decisions appropriately should not need forward guidance. Any message about future policy should be included in the corresponding reaction function. Any additional announcement has a high potential of creating confusion.

The ECB has clarified its modalities for forward guidance in the following way (Monthly Bulletin, July 2013, p. 9): "At the current juncture, forward guidance contributes to the ECB's pursuit of its mandate of maintaining price stability effectively, within the framework and in full respect of its strategy."

### 3. An adequate level of transparency

The adoption of forward guidance as part of central banks' communication strategy has triggered a renewed discussion on the level of transparency in monetary policy. This is anything but surprising as elements of forward guidance – clarifying the future path of the interest rate and other policy instruments and disclosing information about the central bank's perception of macroeconomic fundamentals in greater detail – seem to signal a maximum degree of transparency.

Successful communication is one of the greatest challenges for monetary policy. The more convincing central banks can explain the reasons for their monetary policy decisions to the public, the more effective their monetary policy will be. <sup>2</sup>

Experience has shown, however, how difficult it is to communicate to the public all the information relevant to the decision-making process in a way that is not only exhaustive, but also clear and comprehensible. Monetary policy decisions are complex and the environment is constantly changing. There is uncertainty about prevailing economic conditions and the nature and dimension of economic shocks. As a consequence central banks should abstain from communicating any unconditional commitments to future policy conditions.

Central banks are confronted with the challenge to address very different target groups including academics, the markets, politicians, and the public at large. Monetary policy takes effect via financial markets whose agents are directly affected by monetary policy decisions. Misperceptions of monetary policy activity can cost them dearly. Consequently, praise and complaints from the markets have understandably become permanent companions of monetary policy. Central banks are therefore exposed to the temptation of ascribing an importance to market reactions that goes beyond their "transmission" interest.

There is a high risk that forward guidance will maximize this problem. The more detailed the central bank distributes information, the higher the risk that "markets" interpret the information in a way that is different from the view of the central bank. This will be almost unavoidable if diverging opinions of the members of the decision-making body are published. How will the central bank react in such a situation? Adjust its own assessment to that of the markets or "disappoint" market expectations?

It is interesting in this context to mention an event which happened at the meeting of the Swedish Central Bank's Executive Board on 1 September 2010. Lars Svensson, the deputy governor believed that the repo rate path in the main scenario of the bank was unreasonably high and "claimed that if the repo rate path in the

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<sup>2</sup> See Issing, Otmar, "Communication, Transparency, Accountability: Monetary Policy in the Twenty-First Century," Federal Reserve Bank of St. Louis Review, March/April 2005.

main scenario is supported by the majority of the board, one must hope that it is still not credible and thus will not have very large consequences before it can hopefully be corrected at the next monetary policy meeting". No doubt, this is a very transparent communication. But, what consequences should markets take? The logic of a concept of "full transparency" leads to an endless process. "Markets" will never be fully satisfied before monetary policy decisions are more or less preannounced.

There is, however, another dimension of the predictability of decisions. In the medium to longer term, it becomes a question of consistency between the sum of individual decisions and the longer term objectives of monetary policy. If such consistency is achieved, monetary policy is predictable and credible in the long term. Reconciling the two different dimensions of predictability is and will remain one of the main requirements of communication and monetary policy per se. It is hard to see how forward guidance can meet this challenge.

In this context it seems obvious that the central bank cannot and therefore should not commit itself to objectives which are beyond its competence. There is a high risk for the credibility and reputation of central banks if they accept or even claim responsibility for real variables like unemployment or growth over which they have no control.

The ECB has been criticized from the beginning as being intransparent by not publishing minutes including votes by individual members. I think this critique is – to put it mildly – unfair. The media, e.g. presented the Fed as an opposite, exemplary model of transparency at a time when they praised a chairman who openly – only half jokingly – declared that he must have made a mistake when somebody claimed that he understood what he said.

In contrast to a widely entrenched view the ECB has no reason to be with its communication policy in the defensive. With the press conference of the President and the introductory statement immediately after the monetary policy decisions the ECB set a standard for real time information. The Monthly Bulletin which is published timely gives detailed information on the ECB's assessment of the situation. The term "introductory statement" has a clear psychological disadvantage compared with the title "minutes" as the latter gives the impression that reading it comes close to

having participated in the meeting itself. However, this is far from reality. "Minutes" are well drafted documents.

At the FOMC meeting of 27 and 28 January 2004 the discussion on whether the time lag before publication of the minutes should be reduced from six weeks to three elicited the following objections: "Some members expressed concern, however, that accelerated release of the minutes might have the potential to feed back adversely on the deliberations of the Committee and on the minutes themselves. The members also emphasized the importance of allowing sufficient time for them to review and comment on the minutes and for reconciling differences of opinion among the members of a large and geographically dispersed committee."

In this respect it is important to bear in mind the very different institutional arrangement for the ECB compared to other central banks: Many critics of the ECB ignore the special character of being a central bank of the currency of a large group of sovereign states. The publication of every council member's vote and argumentation could have a significant impact on their contributions, the integrity of members' voting could be compromised. The media and public will tend to connect decisions and votes with the national background. Maybe this applies for the executive board members only to a limited extent, but certainly this would be an issue for the national central bank governors facing pressure if they are regarded as supporting measures that might be reasonable for the euro area as a whole, but go against the national interest of their home country. Immense economic divergences across the members of the euro area only intensify such pressures. Hence, transparency could not only reduce the readiness of people to be fully transparent, but could provoke decisions by members of the governing council to turn actually more national.

Finally, a legal aspect should not be ignored. The ESCB Statute says in Art. 10.4: "The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public".

#### 4. The status of independence of the central bank

The discussion of expanding the mandate of the central bank – a request which has strong political support in some European countries – and heavy purchases of government bonds have triggered a discussion on the independence of central banks.

In the longer run there is no trade-off between price stability and goals like employment or growth, and considering that the effects of monetary policy decisions have a rather long time-lag, a single mandate – price stability – is the logical consequence. A dual – or even triple etc. – mandate blurs the final possibilities and therefore responsibility of the central bank. The government will always give priority to fighting unemployment and implicitly have a bias for short-termism. Under such an arrangement a central bank voluntarily or under political pressure is always tempted to embark on a more expansionary monetary policy.

This is behind the distinction between “de jure” and “de facto” independence (see e.g. Cargill and O’Driscoll 2012). If the central bank’s independence status is exposed to strong political opposition, giving up independence de facto might be seen as an option to preserve de jure independence. However, this would come at the expense of undermining the fundament of independence for the central bank.

The decision to make a central bank independent is a deliberate act of “self-deprivation of power”, and by agreeing on such an arrangement parliament so to speak protects itself against itself. By its own logic this transfer of power excludes policies which need political approval. This is needed for all decisions with the objective of redistributing wealth. In a democracy such acts must be subject to parliamentary control. It is true that monetary policy unavoidably will have distributional effects. However, one of the strongest arguments for price stability is that inflation hurts those most that are unable to protect themselves against its consequences – i.e. the weakest members in society.

In any case, a central bank must abstain from measures which are directed to have distribution effects, like giving cheap credit to special groups and not to others. Redistributive monetary policy is a complex concept. A central bank which is embarking on such a course will have to explain or rather justify its decisions in political fora and cannot refer to “immunity” based on its independence status. This



is probably even more relevant if a central bank in its function of bank supervision authority has the task and power to save or close a bank. This implies that the supervisor, i.e. the central bank, will be heavily involved in the actions of fiscal authorities as providers of taxpayer's money, which could result in political pressure jeopardizing the central bank's independence (de Larosière 2009, p. 43).

Central bank independence is always under threat. From inside (de facto), from outside in legal terms (de jure), and via appointments. The central bank is an institution of and within society. In extreme situations such as a sovereign default or a total collapse of the financial system, the central bank might lose "strategic independence", which means nothing less than that principles of sound monetary policy are put aside.

It does not come as a surprise that preferences in government, parliament, and the wider public for independence might change over time (Goodfriend 2012 calls it an "elusive promise"). A central bank can defend its independence status only to the extent that it delivers on its mandate, communicating its policy to the public in a transparent and coherent way – but also by abstaining from all measures which imply "de facto" dependence. Beyond that the status of independence – de jure and de facto – is exposed to changes in preferences of politics and society. "Not even an independent central bank can lastingly defend monetary stability against a 'society of excessive demands' – in other words, every society gets the rate of inflation it deserves and basically wants" (Issing 1993, p. 36). However, this is not an argument for the central bank to "surrender" by giving up de facto independence.

## 5. The limits of monetary policy

Some decisions taken by the ECB have triggered a dispute whether those measures are warranted by its mandate. I will not enter into the legal case before the German constitutional court, but will rather concentrate on the economic (and political) aspects of the OMT program.

A group of economists has criticized the "attacks by some economists, politicians and observers". It is certainly downplaying the critique by reference to "some

economists". However, the number of supporters or opponents is not relevant. What matters is the validity of the respective arguments.

And in that respect, this group of economists puts is rather blunt: "We consider these attacks as wrong in substance, misguided in intent and harmful to Europe and the global economy."

Are the arguments straightforward convincing? And if not does this verdict not sound arrogant?

1) "... on the substance, the criticisms are based on a faulty understanding of the responsibilities of central banks. In its role as lender of last resort, a central bank must ensure that its liquidity reaches all parts of the economy".

This seems to me a new or rather strange interpretation of the role of lender of last resort which is usually defined as providing unlimited liquidity to illiquid but solvent banks at a penalty rate. It is obvious that OMT is not in line with this definition.

Leaving terminology aside to claim that the "OMT program is an essential monetary policy element for the ECB to be able to fulfill its primary mandate of achieving price stability" is difficult to understand. And to refer to the actions of the Bundesbank in purchasing financial assets – i.e. government bonds in the past – as an act of "lender of last resort" is just wrong. However, to claim that the OMT program is in this regard "not different from any other monetary policy instrument" is confusing as it is denying the difference between the purchase of government bonds of the sovereign by a national central bank to influence interest rates and fighting the risk of deflation on one hand and the purchase of government bonds of member states of EMU in trouble – and not buying bonds of all member states on the other hand. In acting this way the central bank intentionally exerts distributional effects. As already mentioned measures of this kind must remain in the domain of fiscal policy on the basis of democratic accountability. Denying this and just declaring OMT as a monetary policy instrument lacks any logic.

The confusion is also visible from the fact that the authors put “programs to purchase debt of their sovereigns (!)” on an equal footing with selective purchases of bonds of member states in difficulties.

- 2) What is in the best interest of Europe (and Germany) cannot be just explained by the success of the sheer announcement of the OMT program. If this is a measure which transgresses the border between monetary and fiscal policy then the announcement as such is endangering the reputation of the central bank indicating that – if needed – it would undertake inappropriate measures. In fact, once the ECB will start this program it will become a prisoner of politics and markets. “Of politics” because the central bank will have to rely on the conditionality defined by politics. Could one imagine that the ECB would say no because labor market reforms highly praised by “Brussels” do not meet any reasonable standard? The ECB turns into a prisoner “of markets” because it is hard to expect that the ECB would consider suspending interventions if conditionality is not fulfilled. The foreseeable turmoil in markets would deliver a strong argument not to withdraw from interventions.
- 3) The “attacks” are declared as “harmful because they risk weakening the ECB’s ability to carry out its role of lender of last resort thereby risking a deepening of the European crisis and an even more severe spillover to the global economy”. Again referring to the role of lender of last resort is misguided. And warning “that any attempt to limit the independence and flexibility of the ECB to pursue its mandate risks a deepening of the European crisis and risks a wider global crisis” reveals a basic flaw in the statement. Nobody from outside can limit the independence of the ECB. It is protected at the constitutional level. But, independence of a central bank has limits within its statute. The independence of the central bank is constrained to conduct a monetary policy to primarily maintain price stability. The argument that the OMT program is just an element of such a policy is wrong. But, if the effect on “price stability” would justify any measures one could also argue logically that implementing price controls should also be open to decisions by the central bank. And bringing “independence and flexibility” to the same level indicates a peculiar misunderstanding of the appropriate role of the central bank and its reputation.

If the statement of the group is interpreted as just a kind of political manifesto, the debate has to be conducted with political arguments like: What is the nature of the crisis, how should responsibilities be allocated between different authorities, and what will or should be the “finalité” of European integration.

If the statement is based on economic arguments it is hard to understand why the authors are so convinced that they are absolutely right and “the others” lack any economic sense.