EUROPEAN CENTRAL BANK

SEC/GovC/X/02/32
DIRECTORATE GENERAL ECONOMICS

STRICTLY CONFIDENTIAL
29 January 2002
DMP/1120/01

CLARIFYING THE NATURE OF ECB SUPPORT FOR GENERAL ECONOMIC POLICIES IN THE COMMUNITY

1. Institutional background

In response to the inflation experience of the 1970s and 1980s and in line with e re-affirmation of classical tenets of economic theory recent decades have witnessed far-reaching reforms of monetary constitutions across the world. These reforms reflect a broad consensus hat societ 's wider goals are best served if monetary policy is delegated to an independe t centr l bank whi h is given the primary objective of price stability.[1]

As part and parcel of assigning to an independent central bank t primary objective of price stability central bank charters typically contain a clau calling on he central bank to also support, where possible, the general economic policies of the go ernment.[2] uch clauses acknowledge that also an autonomous central bank which is assigned a cl ar prim bjective, as a public body, does not operate in an institutional vacuum.[3] The logi of set ing a clear primary objective, the maintenance of price stability, in conjunction with a qualified presumption of support for general economic policies and society's wider goals also applies to Arti le 10 1 of the Treaty:

"The primary objecti e of th ESCB shall be to maintain price stability. Without prejudice to the objective of price stabili e ESCB hall support the general economic policies in the Community with a view to cont buting to the chie ment of the objectives of the Community as laid down in Article 2."

This formul ion suggests hat – like all Community institutions and the Member States – the ECB shares the bjectives of the C mmunity as set out in Article 2 of the Treaty. These include, *inter alia*, " ustainable and non-inflationary growth respecting the environment", "a high level of employment and of ocial protecti n" and "raising the standard of living and quality of life".

Howev r the general mandate to support "general economic policies" contained in the second sentence of Article 105.1 is qualitatively different from the ECB's primary and direct obligation to maintain price

1 The economic rationale behind this consensus is based on the long-run neutrality of money (long-run vertical Phillips Curve) and on the recognition that attempts to exploit any short-run trade-offs between prices and activity in a systematic manner may lead to an inflationary bias in monetary policy.

2 A wording almost identical to Article 105.1 was used, inter alia, in the Bank of England Act and in the Bundesbank Law.

3 Similarly, modern central bank charters typically include reporting requirements in the interest of accountability as the reverse side of independence of a public institution in a democratic society.

stability.[4] The Treaty has not given the ECB direct responsibility for any additional objectives other than price stability. In particular, the Treaty language does not refer to "secondary objectives" of the ECB.

Nevertheless, since its inception the ECB has faced recurrent demands that the single monetary policy be actively oriented to growth and employment goals in addition to serving its primary objective of maintaining price stability. Such demands tend to arise, in particular, in periods when risks to price stability are judged to be low (or non-existent) while economic growth and employment creation are weak.

The remainder of the note reviews in more detail how the ECB's monetary policy strategy takes into account both aspects of the Treaty mandate while always preserving a clear focus on price stability. Section 2 discusses how the maintenance of price stability and the medium-term orientation in the pursuit of this objective contribute to conditions conducive to sustainable growth and employment creation as well as embodying some degree of output stabilisation as a consequence. Section 3 goes through the main arguments that explain why, by contrast, monetary policy is usually not given any additional "secondary objectives". Section 4 briefly addresses some alternative interpretations of the second part of the Treaty mandate in the context of the ECB's monetary policy strategy.

2. How maintaining price stability over the medium-term contributes to the Community objectives

Given the primary objective assigned by the Treaty and the strict conditionality attached to it ("without prejudice") the ECB can contribute to the wider Community objectives in three ways:

- *by fulfilling the primary objective* of price stability, which creates favourable conditions for sustainable growth, employment and society's welfare more broadly; (price stability as a <u>necessary condition</u> for long-term fulfilment of other objectives)
- by taking other objectives into account in determining *how* the central bank goes about achieving its primary objective; (other objectives <u>embodied in the framework</u> for the pursuit of price stability)
- by reacting to growth and employment as *indicators* of future price developments and by influencing such variables as elements in the monetary *transmission* process; (role as <u>information and transmission variables</u> for price stability)

This suggests that both elements of the ECB's mandate need to be understood *in conjunction* and not in isolation. In particular, the second part of the ECB's mandate can be seen as indicating that the ECB's primary objective is not to be pursued "blindly" but with an eye on the Treaty's wider objectives. These objectives are embodied in the design of the framework guiding monetary policy decisions (in all three respects discussed in more detail in this section). *Given* this framework, the maintenance of price stability over the medium term is the ECB's best contribution to fostering an environment favourable to

[4] In this context also note that the formulation and indirect reference in Art. 105.1 ("support … with a view to contributing") is identical to that applied to the Member States' national economic policies (Art. 98, ex Art. 102a).

sustainable growth and employment in the longer run and it is also its best contribution to limiting unnecessary volatility of output and employment in the short run.

a) *Maintaining price stability is the best contribution of monetary policy to growth and employment in the long run*

Maintaining price stability and real economic objectives are not in conflict but complementary in the long run. Price stability enhances the working of the price mechanism and promotes efficiency in the allocation of resources. Price stability also minimises the inflation risk premium in long-term interest rates and preserves the purchasing power of consumers and wage-earners. Through all these channels the maintenance of price stability contributes to creating favourable conditions for sustainable economic growth and supports the Community's general economic policies in this regard.

b) *Maintaining price stability over the medium term avoids introducing unnecessary volatility into real variables and embodies a concern with and a contribution to the stabilisation of output and employment*

The Treaty states the ECB's objective, but does not specify how it should be achieved. As part of the announcement of its monetary policy strategy the Governing Council has, therefore, provided a quantitative definition of price stability and has stated that price stability is to be maintained over the medium term. The medium-term orientation of the ECB's monetary policy strategy reflects two main considerations:

i. Monetary policy transmits to economic variables and price developments through a variety of channels with long and variable lags. Given limited knowledge monetary policy is ill-equipped to fine-tune economic developments or control prices at short horizons. Activist policies directed at exploiting short-term trade-offs between prices and activity risk contributing to instability over longer horizons.

ii. Focusing on maintaining price stability over the medium term avoids introducing additional, unnecessary volatility into the economy. Higher-frequency fluctuations in prices – which are in any case largely beyond the control of monetary policy – can be accommodated and concomitant variations in real variables can be contained as a natural by-product of a monetary policy geared towards maintaining price stability over the medium term. Thus a concern with fluctuations in real economic variables is taken into account in the medium-term orientation of the monetary policy strategy and in the need to calibrate the appropriate monetary policy response to the nature of shocks allowing for gradualism in restoring price stability.

Given the medium-term orientation of monetary policy price stability and real economic objectives are not in conflict but complementary for a variety of circumstances:

- Demand shocks: In this case output and prices tend to move in the same direction and a price stability oriented monetary policy response will also stabilise output at the same time.

- Supply shocks: In this case, output and prices tend to move in the opposite direction. A medium-term oriented policy allows for a gradual and measured monetary policy response in order to avoid the introduction of unnecessary volatility into real variables.[5]

- Prominent role for money: an orientation of policy at the information content of monetary developments with a medium term perspective is also consistent with some degree of “built-in” stabilisation since the demand for money reflects both output and price developments.

- Credibility: A clear focus on medium-term price stability provides a reliable anchor for expectations and situations giving rise to a trade-off between output stabilisation and price stability (such as a cost push/wage shock) will become less likely to arise. Moreover, any such trade-off will become the less pronounced the more credible the central bank’s commitment to price stability is.[6]

In these ways the design of the ECB’s monetary policy strategy geared towards maintaining price stability over the medium term serves the Community’s wider objectives in Article 2 (to the extent that theses are pertinent to monetary policy). This does not imply, however, that day-to day monetary policy decisions are actively directed at any additional objectives. Instead, output smoothing results as a natural consequence but not as an additional independent objective *within* such a medium-term framework.

c) A monetary policy geared towards maintaining price stability over the medium term in most cases implies stabilising responses to real economic indicators

Within the context of the ECB’s strategy monetary policy will naturally react to output, growth and other real variables as indicators (rather than as objectives) to the extent that this is needed to maintain (or restore) price stability over the medium term. As noted above, for some kinds of shocks (namely demand-driven shocks) the policy appropriate for maintaining medium-term price stability will also entail a stabilising short-run effect on real variables. In this particular case maintaining price stability monetary policy contributes to shorter term output and employment objectives as a consequence. However, the reverse reasoning does not hold. Stabilising output and employment does not in general secure price stability.

Therefore care must be taken to avoid that the role of output and employment as indicators or transmission variables in the monetary policy strategy is misperceived as representing independent objectives in their own right. Such an interpretation would make it more difficult to maintain or restore price stability in situations where a trade-off may arise.

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5 The notion of a supply shock is not unambiguous. If this refers to changes in potential output a trade-off between the stabilisation of output (or rather: the output gap) and price stabilisation may not arise, unlike in the case of a “cost-push shock”.

6 These considerations may explain empirical evidence showing that independent central banks pursuing price stability have not only achieved lower average inflation and lower inflation variability but have done so without any “cost” in terms of higher output volatility.

3. Economic arguments against directly pursuing additional objectives

The ECB's monetary policy is oriented towards achieving the single objective of price stability at the appropriate medium-term horizon. This can be shown to be theoretically largely equivalent to the adoption of a price stability objective at all times together with a preference for output smoothing. However, giving monetary policy an additional active stabilisation role for real activity (beyond what is already embodied in the medium-term oriented framework for the maintenance of price stability) would be likely to overburden monetary policy in practice. More specifically, any direct orientation of policy at additional "secondary objectives" has the following drawbacks, related to practical feasibility, on the one hand, and considerations of a political economy nature, on the other hand:

a) Monetary policy cannot affect long-run output and employment. The information requirements for successful active stabilisation of output around some (unobservable) natural or potential rate go beyond the limits of what is feasible in practice. In particular, trend and cyclical developments in growth and employment are hard to disentangle.

b) Emphasis on growth and employment concerns is likely to be time-varying and asymmetric (being more pronounced in periods of economic weakness). This may create a perception of discretionary shifts in central bank objectives and of inconsistencies in the conduct of monetary policy over time (leading to an inflationary bias).

c) Due to long and variable transmission lags activist policies aimed at fine-tuning of price or output developments at short horizons are prone to end up having pro-cyclical and destabilising effects.

d) Effects of monetary policy tend to show up first in real variables, while consequences for price developments only appear with considerable delay. Thus short-term cyclical concerns are likely to crowd out the focus on medium term stability.

e) Any direct emphasis on output objectives may create credibility problems for monetary policy and thereby worsen possible trade-offs (i.e. stabilisation of prices may become more costly in terms of lost output in the short term).

f) Explaining monetary policy with reference to multiple objectives would complicate communication and may generate unrealistic expectations about the abilities of monetary policy to manage the economy more generally. This, in turn, may exacerbate imbalances in the economy and delay or impair self-adjustment mechanisms of markets.

g) Taking on an active role for output stabilisation – even if feasible – may divert attention away from the respective responsibilities of other policy areas for growth and employment, undermining a clear allocation of accountability and affecting policymakers' incentives adversely.

Against this background, it does no appear advisable to construe the second element in the ECB's mandate in a way that reverses the basic economic logic underlying the assignment of a clear primary objective by suggesting that the ECB should actively pursue other objectives subject to the "side-condition" that price stability is maintained. Such a switching of roles between the primary goal and additional independent "secondary" objectives carries the risk of crowding out and obscuring – even if only temporarily – the ECB's overriding focus on price stability with the attendant risk of longer-term damage to credibility.

At the same time, care needs to be taken to avoid that monetary policy is seen as pursuing price stability "blindly" and in disregard of the second part of its Treaty mandate. Therefore it may be considered to further strengthen the ECB's emphasis on how the maintenance of price stability over the medium term supports the growth and employment as explained in Section 2.

4. Alternative interpretations of the Treaty mandate in the framework of the ECB's monetary policy strategy

The arguments presented in the previous sections explain why the Treaty – like most modern central bank charters – has not assigned the ECB any additional direct objectives other than price stability while the ECB naturally shares and supports the wider Community goals and policies. This means that the second part of the ECB's mandate as given by the Treaty does not lend itself to a straightforward operationalisation (beyond general implications for how price stability is maintained over the medium term as set out in Section 2). Nevertheless a number of alternative, further-reaching interpretations have been advanced :

i. *"Once price stability is achieved (or whenever there are no risks to price stability) interest rates can be set to support other objectives."*

This interpretation seems to neglect that monetary policy needs to be forward-looking, that the transmission process and the future evolution of the economy are subject to uncertainty and that a single instrument is not suited to control two independent variables simultaneously. In other words, if the original stance of monetary policy is always set to best serve the primary objective, any change in that stance in the pursuit of other objectives is likely to affect the time path and risk profile regarding future price developments. Therefore price stability, strictly speaking, can never be regarded as secured and – in a probabilistic sense – does not "free up" the policy instrument to switch to other independent objectives in the way the interpretation above suggests.

ii. *"The ECB's definition of price stability as a range provides leeway to set interest rates at the lowest possible level consistent with the definition in order to contribute to maximum growth."*

As before the perceived leeway largely disappears once uncertainty and the time dimension of policy choices are considered. Thus the appropriate stance of monetary policy needs to ensure that price stability will be maintained according to the defined range with a high probability, i.e. effectively aiming at inflation outcomes "safely below 2%" and "well above 0%" taking account of the nature of risks to price stability. Aiming for inflation outcomes of "just below 2%" would imply a high probability of exceeding the 2% ceiling for prolonged periods (and the argument applies, similarly, in the opposite direction). The appropriate safety margin with respect to either boundary of the definition of price stability will depend on economic circumstances and on the time horizon that is considered.

Under both of the above "mechanical" interpretations of the Treaty mandate any active use of a perceived room for manoeuvre for some "extra" lowering of official interest rates is likely to carry some *costs*. This could come in the form of an increased likelihood that such a move would have to be reversed (and compensated in the opposite direction) later on. It is then no longer obvious whether it is necessarily the *lowest* level of (short-term) interest rates regarded as consistent with price stability at a particular point in time which best serves growth and employment objectives in a sustainable manner. In addition, also the distributions of expected long-term interest rates and of inflation expectations may be affected adversely. Against this background it is not clear at which point any risks taken with regard to the future evolution of prices cease to be negligible and give rise to a trade-off that can no longer be regarded as "without prejudice to price stability".

Even if the potential costs for medium-term price stability of an interest rate adjustment in support of other objectives are judged to be negligible at any specific point in time, the *benefits* of any extra output and employment are likely to be very small and transitory. Any such small and uncertain economic benefits have to be weighed against the risk of creating excessive and unrealistic expectations about the role of monetary policy in promoting growth and employment (and the other drawbacks listed in Section 3) as well as the possible related longer-term damage to the consistency and credibility of the monetary policy framework. In particular, the above interpretations may overcome undermine the primacy of the price stability objective expressed in the Treaty and nurture the illusion that other objectives can be pursued independently in an active manner. Even if feasible theoretically, this would overburden monetary policy and thus in the end turn out to be prejudicial to price stability in practice.

Finally, the two alternative interpretations considered in this Section are likely to give the misleading impression that growth and price stability objectives can be divorced and served separately by monetary policy according to circumstances. This is likely to distract from the substantial benefits for growth and employment that can be reaped *through* the maintenance of price stability over the medium term. As a result public support for price stability and central bank independence could be weakened.

By contrast the reasoning presented in Section 2 suggests that the ECB always sets interest rates at a level which best serve the maintenance of price stability over the medium term. In always focusing on the maintenance of price stability over the medium term the ECB takes other Community objectives into account without prejudice to its primary objective of price stability. The appropriate level of interest rates for medium-term price stability thus, *at the same time*, provides the ECB's best contribution to sustainable growth and employment. Both objectives go hand-in-hand over and beyond the medium term. This fundamental complementarity is backed by economic theory and empirical evidence. It provides the political foundation and legitimacy for central bank independence and it is a recipe for clear and credible communication.