From Hard Currency Policy to Monetary Union

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Abstract

In the wake of monetary integration in Europe, Austria abandoned the tested hard currency policy (HCP) for joining EMU as a member. The final target of monetary policy and real sector adjustment needs are similar in both regimes, and the HCP may therefore be viewed as a convenient "training camp" for later EMU accession. Georg Winckler devoted a number of essays on the critique, but also on the analytical foundation, of the HCP. The current paper takes up some of the strands developed by him, and reviews the implications on Austria's monetary strategy of the changeover to EMU. At EMU level it was required to newly establish credibility and accountability of the monetary authorities. Towards this end, the ECB emitted harsh signals to be committed to its primary task of maintaining price stability, and it was therefore held accountable for neglecting real sector developments as well as potential threats of deflation. This is unjustified, given the circumstances the ECB has been faced with since its inception, including the marked swings in the dollar value of the euro. The ECB could be blamed, however, for the lack of transparency with regard to its monetary strategy (which it declines to be "inflation targeting"): it resorts to a rather vaguely defined final monetary target, it does not observe an intermediate target, and it is by no means clear what purpose the reference value for money growth does serve. The paper concludes that in Europe there is no immediate danger that the goal of price stability could unintentionally end up in deflation.

1. Introduction

Georg Winckler has devoted much of his written work to monetary issues, in particular to Austrian and European monetary and exchange rate policies. However, monetary thinking to him has never been limited to the sheer link of monetary instruments to some intermediate

monetary target, his focus has always also been on the final goals of policy making, and thus on the interdependencies between the monetary and the real sectors of the economy. Similarly, policymaking to him is a task to be accomplished in a multidimensional space where the stakes of politicians, social partner interest groups, business and households meet and perhaps clash on each other. Austria is a convenient empirical playground where the behaviour of all these agents can easily be comprehended and the outcomes studied. Georg Winckler has closely followed the institutional changes in the wake of integrating Austria's hard currency policy into the European Economic and Monetary Union (EMU) and has contributed to the understanding of the extended system up to the topical point of including the effects of enlargement.

The following remarks build on some of the ideas of Georg Winckler and undertake to assess the implications on Austrian policymaking and economic performance of the changeover from the unilaterally declared hard currency policy to full EMU membership. In this context, the issues of inflation targeting, the monetary strategy of the European Central Bank (ECB), the actual policy stance of the European System of Central Banks (ESCB) and current threats of deflation will be discussed and examined as to their relevance for economic developments in the EU.

2. Austria's Hard Currency Policy: "Training Camp" for Monetary Union

Gradual Changeover From a "Weak" to a "Hard" Schilling

Up to the early 1970s, economic policy in Austria was devoted to stabilizing the demand conditions, though not exclusively. Incomes and price-setting policies of the social partners were monitored by the Government, and supply-side-oriented state aid was extended to investments and exports. As an outgrowth of the Bretton Woods system, the nominal exchange rate of the schilling was fixed vis-à-vis the dollar. Austria did not follow the revaluations of the D-mark, thereby gaining room for the catch-up with the more advanced trading partners in western Europe. Monetary aggregates were accommodating to aggregate demand. However, a supply-side element was also included in money creation, as money was selectively channelled via the export sector and towards investment projects. To avoid short-term overheating of the economy, the growth of new bank loans was limited. In addition, monetary authorities pursued an *"active policy of nominal interest rate constancy"* (WINCKLER, 1979) which was not completely in vein given the inefficient money and capital markets of the time.

As far back as in the early 1970s, Austria began to complement these policies by a *more active exchange rate policy* which was not any more purely linked to the traditional IMF policy of counteracting fundamental disequilibria in the balance of payments. The aim was rather to dampen imported inflation. This policy was strengthened in the period of the

stepwise breakdown of the Bretton Woods system, when the exchange rate of the schilling was pegged to a basket of trading partner currencies. In the wake of the first oil crisis in 1973, the schilling was by and by tied to the D-mark[1]), eventually accomplished in 1981 (HANDLER, 1989).

The *"hard currency policy"* (HCP) of the 1970s and 1980s used the exchange rate rather than a monetary aggregate or an interest rate as the major intermediate target of monetary policy. The exchange rate was deemed easier to steer by the authorities and better to comprehend by business and labour. Besides (a) smoothing out short-term exchange rate variations, the HCP aimed at the following *goals*: (b) stabilising inflation at low rates, (c) mitigating inflation variability and uncertainty, and (d) putting cost pressure on business to improve international competitiveness (KOREN, 1988).

The hard currency strategy was superimposed on the traditional monetary strategy, thus creating a hierarchical *system of intermediate monetary targets*, where an appreciating schilling exchange rate was seen to contain inflation expectations and variability, directly or via incomes policies, and this in turn would stimulate real sector activities. Interest rates did not play an immediate role in this context, though an appreciating schilling rate was expected to reduce interest rates, which in turn would stimulate credit demand and physical investments. Monetary aggregates, in contrast, had no independent role, but were seen to be determined by the credit channel and to kindle repercussions on the external balance.

As regards the final goal of monetary policy, the *"Scandinavian model of inflation"*, as adapted to Austria by FRISCH (1976), was employed by the authorities to explain the virtues of stability import from Germany: Market prices in the stable anchor country are given to a small open economy, and they are transposed, by way of a stable exchange rate, to the exposed (international) sector of the home country. Wage increases in this sector are limited by competitive pricing. Strong unions establish solidarity among workers across sectors and ensure moderate wage increases also in the sheltered sector. WINCKLER (1997) has referred to this causal chain as an "inverse purchasing power parity relationship" in a two-sector economy.

"Austro-Keynesianism" or Rather "Austro-Monetarism"?

While pursuing a HCP, Austria did not abandon the traditional Keynesian instruments of fiscal and incomes policies. The particular policy mix of the 1970s, termed *"Austro-Keynesianism"*, combined monetary restraint (to dampen inflation) with fiscal expansion (to secure full employment), both being backed-up by productivity-oriented wage developments. HOLZMANN – WINCKLER (1983, p. 184) characterise it as "Austrian policy mix of demand management mixed with elements of supply side economics (as investment-, savings-, export

1) A major exception of this policy occurred during the balance of payments crisis of 1976/77, in the wake of which the schilling temporarily depreciated against the mark.

or labour market promotion), supported by hard currency policy and incomes policy based on accord between the social partners." And they continue that this home-made concept "incorporates classical relics, neo-classical extensions, monetaristic presumptions, or just common-sense economic policy besides some kind of Keynesianism". Given the pretension to stabilise expectations via transparency (concerning monetary conditions and policy intentions), the hard currency option was quite close to monetarist thinking. Therefore, some observers preferred the term *"Austro-Monetarism"* over the established term "Austro-Keynesianism"[2]).

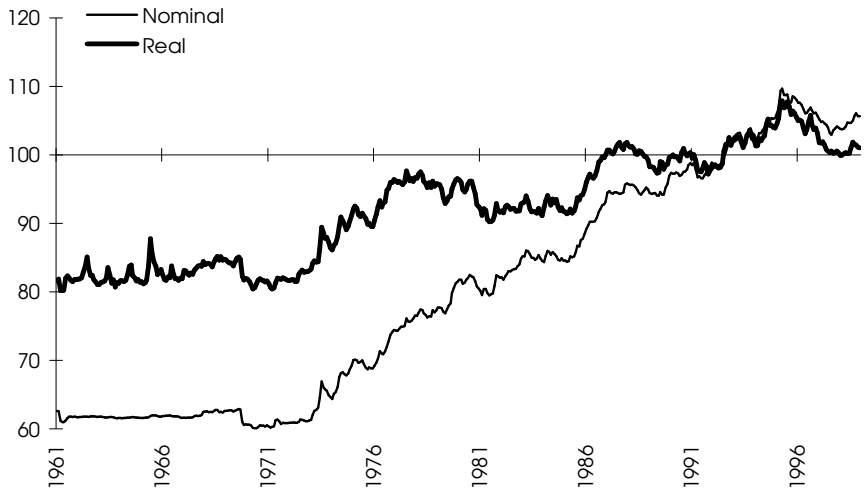
In practice, the HCP helped *stabilise inflation expectations*, and thus not only create a solid calculation basis for export-oriented business, but also to cut down on the problem dimension for policymakers: Monetary stability enabled politicians to devote all their decision capabilities on problems in the real sector of the economy (HANDLER, 1989, p. 26).

By the end of the 1970s, the Austrian inflation rate was reduced almost to the German level, thereby remaining much below the average inflation in other trading partner countries. However, due to the comparatively weak budgetary and current account position of Austria, a small inflation differential vis-à-vis Germany remained[3]) and was reflected in somewhat higher interest rates in Austria than in Germany. At the same time, GDP growth was higher than in Germany, at least up to the early 1980s. Overall the HCP dampened inflation, without impeding real growth. This was mirrored by the development of *effective exchange rates*: nominal effective appreciation was for many years (from 1977 to 1985, and again from 1988 to 1992) accompanied by real effective depreciation (Figure 1).

2) The term "Austro-Keynesianism" was coined by SEIDEL (1982), while HABERLER (1982) characterised the Austrian policy mix as "Austro-Monetarism". The latter term was also favoured by SOCHER (1982).

3) HOCHREITER (2001) relates the comparatively high Austrian inflation rate to the Balassa-Samuelson effect which explains, for a two-sector economy, a positive inflation differential of a catching-up country (Austria) vis-à-vis a more advanced country (Germany) by faster productivity catch-up in the exposed sector than in the sheltered sector.

Figure 1: Nominal and real effective exchange rates
1992 = 100



S: WIFO database.

Real Wage Flexibility Secured by Strong Unions

In case of a negative supply shock from abroad, real depreciation would be necessary to maintain full employment. If the monetary authorities resorted to nominal depreciation, the employment goal could only be achieved if the unions were (strong and) *co-operative* and did not strive to compensate the nominal depreciation by higher wage claims. Therefore, to arrive at the results desired by the monetary authorities, the comprehension by the trade unions (and the employers' organisations) of the channels offered by the Scandinavian model was indispensable.

Georg WINCKLER has long been a keen observer of the strong influence of the social partners on policy decisions in Austria. With regard to the HCP, he emphasised the importance of the *strategic behaviour of strong trade unions*. In a multi-period game between the trade unions and the authorities, WINCKLER – AMANN (1986) analysed the policy options to counter an external shock. They concluded that, from the point of view of the authorities (government and central bank combined) who regard fiscal deficits as costly, the first best solution was not to keep the exchange rate constant, but to permit appropriate changes to counter the real effects of the shock.

However, one has in addition to consider that, starting from a given policy strategy, any change would be costly and could result in a risk premium on the real interest rate. Therefore, in case of an external shock the monetary authorities would tend to stick to their given nominal exchange rate rule. To restore equilibrium employment, the adjustment burden

would predominantly rest on *real wage flexibility* to be warranted by the trade unions (HOCHREITER – WINCKLER, 1995).

In practice, the *unions* in Austria believed in this mechanism which they perceived to minimise the real costs of disinflation, and they were thus in favour of the HCP. In contrast, *industry* representatives during much of the 1970s advocated a schilling depreciation, which they found conducive of improving the international competitiveness of enterprises. Eventually, as from December 1979, even industry was in favour of Austro-Keynesianism and its hard currency arm. The combination of Keynesian deficit spending (in particular in form of state aid to companies) with the price stability effects derived from the monetarist attitude of the Bundesbank, beefed up by real wage flexibility, seemed now optimal also for enterprises.

Informal Monetary Union with Germany

As indicated above, back in the 1970s interest rates and monetary aggregates in Austria would not be completely endogenous in the face of an exogenous exchange rate. In particular, interest rate policy remained active to steer internal economic developments. It was not before the end of the 1970s that the *integration of financial markets* had progressed to an extent which rendered interest rate policy ineffective. In 1979, the attempt of the monetary authorities to keep the interest level in Austria below that of Germany resulted in massive capital outflows and parallel losses of foreign exchange reserves. As a consequence, interest rate policy was subordinated to exchange rate and balance of payments needs, and interest rates were thus brought in line with developments in Germany (HANDLER, 1989, p. 45f).

From the early 1980s, the schilling rate was virtually linked to the D-mark, and Austria became part of an *informal monetary union* with Germany. An immediate effect of pegging the exchange rate (or joining a monetary union) is of course that asymmetric shocks from outside have to be absorbed by other variables than the exchange rate. As HOCHREITER – WINCKLER (1995) emphasised, an exchange rate peg puts pressure on the countries concerned towards convergence, and with convergence the share of symmetric shocks should rise. Of course, comparable structures and policies in the participating countries would themselves facilitate the peg. With regard to Austria and Germany, the authors calculated correlation coefficients between price and quantity changes over 20 industrial branches and concluded that (a) in the 1970s and 1980s, Austria (relative to Germany) was predominantly exposed to asymmetric shocks and (b) in contrast to expectations from the increasing openness of the Austrian economy, no tendency towards more symmetric shocks could be unveiled.

To save the case for monetary union, therefore, the authors investigated into the *mobility of production factors* (which they considered insufficient before the late 1980s) as well as into *real wage flexibility*. They found the latter, as an outgrowth of social partnership, sufficiently high to support a schilling/D-mark peg. Judged by the variability of the real schilling/D-mark exchange rate, they concluded that, by the late 1980s, Austria had come closer to form a

monetary union with Germany than any other of the core candidate countries (Benelux, France).

Although in the late 1970s the preconditions for a monetary union with Germany were not fulfilled, the Austrian authorities, in their endeavour to make this project a success, managed to establish *credibility*. Towards this end, the authorities emitted a strong *signal* that any return to a "weak" currency regime was inconceivable: in September 1979, the schilling was unilaterally revalued against the D-mark by 1.5% (HOCHREITER – WINCKLER, 1992). As a consequence of the newly won credibility, an adjustment process was triggered off which eventually, by way of real wage flexibility, established the conditions conducive to an optimal currency area with Germany. This result was "more the outcome of real wage flexibility in Austria than an increase in the symmetry of shocks" (HOCHREITER – WINCKLER, 1995, p. 91).

The hard currency strategy has been *carried over to EMU* from Austro-Keynesianism, which itself, as a consequence of globalisation and rising public sector debt, was phased out as a comprehensive policy strategy. In this context, the participation of the *social partners* in the decision making process of the hard currency era was reduced to sheer representative functions without any influence in substance. From hindsight, the HCP can be seen as a kind of *"training camp"* which made it easy for Austria to adopt the idea of a European monetary union: With respect to monetary policy, no change in attitude had to be established and communicated to the general public. "Austria can therefore be viewed as an example for the accession of a small country to the European Monetary Union" (WINCKLER, 1997, p. 295).

3. From Exchange Rate Targeting to Inflation Targeting

Well in advance of EU accession, Austria indicated that participation in the Exchange Rate Mechanism (ERM) and later EMU membership were seen to extend the prevailing hard currency regime, as Austria expected the policy stance of the ECB to resemble that of the Bundesbank. However, a "training camp" never completely anticipates reality. To obtain EMU membership, Austria had to adhere to the strict entry and convergence conditions of monetary union, and was in particular forced to slash budget deficits and debt ratios. Therefore, the focus of policy instruments to be applied on the national level shifted from monetary instruments to the area of fiscal and structural policies.

EMU membership comprises a number of aspects that were not taken care of under the HPC. From an Austrian point of view, what are the similarities and the major differences between the two regimes?

HCP and EMU: Some Similarities, Some Differences

For Austria, EMU brought about significant changes in the *decision making process*. The old hard currency regime had been adopted unilaterally and could thus have been abandoned

any time. In contrast, of course, EMU membership is designed to last indefinitely. Austria's membership in the ERM was established by a unanimous multilateral decision on the ECU central rate of the schilling and the bilateral central rates of the participating currencies (HOCHREITER, 2001).

Entry into the Third Stage of EMU stripped the Austrian National Bank (OeNB) of its *national monetary policy function*, but secured, by its seat on the Governing Council of the ECB, Austria's active participation in the decision-making process of European monetary policy. The ECB, on the other hand, decides according to the necessities of the euro area as a whole and is not supposed to take national requirements into account. A monetary policy decision may thus seem more favourable to some Members than to others.

As GNAN (1994) observed, the responsibility for *exchange rate policy* in Austria was previously shared by the Federal Government and the central bank, which helped achieve a broad consensus on monetary issues at large. Monetary and exchange rate policies in EMU are, of course, the sole responsibility of the *ESCB*. In relation to non-Community currencies, however, the Council of Ministers may formulate general orientations for exchange-rate policy and may conclude formal agreements on an exchange-rate system (Art. 111 of the Treaty).

As far as *credibility* is concerned, the monetary authorities may resort to "reputation building", "delegation to a conservative central banker", "principal-agent contracts" or simply to "transparency" (HAHN – MOOSLECHNER, 1999). Under Austria's *HCP*, the problem was solved through a combination of these methods: First of all, credibility was derived from the "conservative" Bundesbank, which itself had already established a reputation of having successfully combated inflation. Over time, the OeNB by itself was able to acquire a track record of being reliable. Neither a principle-agent contract (implying punishment of the central banker who does not achieve price stability) nor transparency did play a special role.

The *ESCB*, though starting out with some reliance on the reputation of the Bundesbank, had no track record of its own, and therefore immediately emitted strong *signals* indicating its determination to seek and maintain price stability, as required by the Treaty of the European Union (TEU). Delegation seemed no way towards credibility, as no other equally "conservative central banker" (ROGOFF, 1985) was around. A principal-agent contract was also not conceivable, as the European principal (the Council, the European Parliament) did not appear sufficiently reliable, given the requirements of the TEU. Transparency was thus the only way possible to reinforce the signals and help quickly establish a track record of a consistent anti-inflationary policy stance.

Transparency in the ESCB indeed covers two objectives: (a) helping establish credibility and (b) contributing to the accountability of European monetary authorities towards a European principal. *Accountability* may easily be obscured in a system where the authorities are virtually independent of ordinary politicians, lawmakers and the general public's opinions. Since the ESCB is guaranteed a rather high degree of independence (encompassing target

definition, instrument selection as well as personal and institutional independence of national and European politics), transparency would soften the accountability problem.

How does the ESCB *in practice* handle the demand for transparency? The answer comprises some positive and serious negative elements: The ESCB established a *positive record* by coming up with a quantitative definition of price stability and a quantitative reference value for the growth of the money stock. It also has adequately communicated the reasons behind concrete policy decisions.

On the other hand, the *ESCB is rather hesitant* to leak information on the results of internal forecasting exercises, as this would increase the chances for misinterpretation and thus contribute to speculation. The ECB also does not communicate the minutes of ECB Governing Council meetings, because they would anyway only be of interest to historians and not contribute to the public's understanding of policy actions. Above all, the quantitative figures concerning price stability and money growth are not regarded by the ECB as target values. This seems to be in contrast to the understanding by the general public, and does therefore not contribute to transparency of monetary policy and accountability of the ECB.

Same Target – New Instruments, Indicators and Institutions

In the European Economic and Monetary Union, a *comprehensive strategy* has been developed to permit the analytical preparation and operational implementation of monetary policy measures as well as their communication to the public by the ECB. The strategy rests on the following principles (ECB, 2001, p. 45):

- Monetary policy must be *forward looking*. Only then can the transmission lags be accounted for.
- Monetary policy must be oriented on *medium-term effects*. Only then can unnecessary activism be avoided which would but amplify volatility in the real economy.
- Monetary policy must be *broadly based*, taking into account all relevant information. Only then can the uncertainty be reduced which accompanies all monetary policy actions.

The *final monetary target* in the euro area is securing "price stability", which is defined as the year-on-year increase in the Harmonised Index of Consumer Prices (HIPC) of below 2%, to be maintained over the medium term[4]). This definition has been criticised by SVENSSON (1999) as being too vague and therefore not being transparent enough concerning the overall monetary strategy of the ECB. As the *operational instrument*, the ECB determines the level of short-term interest rates which it deems consistent with the inflation target. Austria's HCP, in

4) This definition was introduced by the ECB Governing Council in October 1998 and reconfirmed in May 2003. To guard against the risks of deflation, the aim is now to maintain inflation rates "close to 2% over the medium term" (ECB 2003).

order to stabilise the exchange rate at the target value, relied on interventions in the foreign exchange market and on open market instruments.

As regards *intermediate targets and indicators*, there is a decisive difference between EMU and Austria's HCP: While the latter was based on the exchange rate as the dominant intermediate target, in EMU the exchange rate is an endogenous variable which plays (almost) no role in the monetary transmission mechanism. For the euro area, two diverging opinions evolved: One group of economists favoured "inflation targeting", e. g. BEGG (1997), while others advocated money growth, e.g. von HAGEN – NEUMANN (1996) among others. In the event, a *"two-pillar strategy"* evolved for the operations of the ECB which was seen to ensure a consistent and systematic approach to monetary policy decisions:

(1) The first, and most prominent, pillar has been a quantitative reference value for the *growth of money M3*. M3 is conceived as an endogenous variable which is closely related to future price developments. Deviations of actual M3 growth from the reference value would carefully be evaluated as to their information content regarding future inflation. The ECB would not attempt to steer money growth at any point in time. Thus, in the context of the overall monetary strategy, actual growth of M3 is merely an *indicator variable*[5]). It appears less comprehensible that "(t)he reference value is not a monetary target", but just "a visible public commitment on the part of the ECB to assign an important role to money in monetary policy decisions" (ECB, 2001, p. 47ff). Although this is accentuated by leaving the reference value unchanged over time[6]), one could in that case have done without any quantitative value at all. In addition to M3, the ECB considers a number of other monetary variables (components of M3, credit extension and others) on a regular basis as to their information content concerning medium-term price stability.

(2) The second pillar widens this range of indicators to *other economic and financial variables* that are more relevant for short-term price developments. They include model-based (conditional) forecasts, other indicators of price and cost developments as well as of output and demand, labour market data, information on public sector accounts, financial market variables, exchange rate developments and balance of payments statistics.

There has been an ongoing debate concerning the *emphasis on the "first pillar"* of the ECB's monetary policy strategy. In favour of the first pillar are, among others, CLAUSEN – DONGES (2001). The authors abstract from unresolved questions as the slope of the Phillips curve or the endogeneity of the money stock, and investigate rather whether money plays an "active" or a "passive" role in the transmission process. In the first case, excess money would stimulate

5) Practical policy and the media, however, attach to M3 rather the function of an intermediate monetary target.

6) At the start of EMU Stage Three in January 1999, the reference value was set at 4.5% p.a., and it has never been changed since. This figure resulted from the definition of price stability (i.e. an HICP increase of less than 2% p. a.), an estimated trend growth of real GDP for the euro area of 2 to 2½%, and an assumed decline in M3 velocity of ½ to 1% p. a.

demand and cause inflation. In the second case, inflation would be the result of excess demand, and money would simply follow aggregate demand and inflation. The authors argue that, even in the passive case, money would be a useful leading indicator of inflation and should therefore play a role in the ECB's monetary strategy.

Others, including SVENSSON (2000), ALESINA et al. (2001) and GROS et al. (2001), are sceptical about the usefulness of M3 as an indicator. They would abolish the first pillar at all and would exclusively rely on the second pillar. According to GERLACH – SVENSSON (1999), the M3 indicator has almost no predictive power for future inflation and should therefore be stripped of its current prominent role. Casual evidence from recent data seems to support this view (Figure 2). The Sachverständigenrat (2003) has therefore advocated merging the two pillars into one. In response to the critics, the ECB (2003) has recently treated the two pillars more evenly and distinguishes now "economic analysis" to identify short to medium-term risks to price stability from "monetary analysis" to assess medium to long-term trends in inflation.

Figure 2: Growth Rates of M3 and Inflation Rate in the Euro Area
As percent

S: ECB.

The ECB (2001, p. 46f) keenly maintains that the two pillars are not to be regarded as intermediate monetary targets. Rather, they "organise the information and analysis underlying policy discussions" and "constitute a framework within which the forward-looking assessment of the economic situation can be undertaken, based on as full a set of economic information and analytical tools as possible". Thus, *there is no intermediate monetary target of the ECB*. CLAUSEN – DONGES (2001) point at the advantage of setting a reference value for M3 growth rather than establishing an intermediate target: This "allows the ECB to circumvent the

uncertainty about the controllability of euro area M3 – and still make use of the information content embodied in monetary expansion for price level developments in the future." In a similar vein, SVENSSON (1999) applauds the rejection of an intermediate target by the Eurosystem, because it would be inefficient in most circumstances, the exception being conditional forecasts of the target variable[7]).

The question then arises, if the ECB's monetary strategy, in principle designed to enhance *accountability* of the ECB and *transparency* vis-à-vis the general public, does not become arbitrary. Although the ECB is certainly not in a position to steer inflation directly, the strategy is reduced to sheer "inflation targeting", without any intermediate target visible to the public. The two pillars and their indicator variables become the "black box" again which the theory of the transmission channels sought to unveil.

Does the ESCB Rely on Inflation Targeting?

The ECB anyway maintains not to conduct "inflation targeting", as this would require an explicit target value (not just a price-stability definition) and a publicly communicated inflation forecast. Given the uncertainties at the start of the monetary union as to the aggregate behaviour of economic agents (the stability of money demand) and the reliability of the data collected, the ECB abstained from any commitment to a monetary policy rule. This was seemingly in contrast to the strategy of the Bundesbank that regarded the growth of monetary aggregates as an intermediate policy goal.[8]

Already at the time of the European Monetary Institute (EMI), the predecessor of the ECB, a number of *monetary strategies* were considered that would have avoided the black-box trap:

- *Monetary targeting*: The explicit use of a monetary aggregate as an intermediate target was refused because (a) no stable demand for money relationship could be expected at the start of EMU, and (b) the controllability of the money stock by the ECB was questioned.
- *Exchange rate targeting*: Such a strategy was seen appropriate perhaps for small open economies, where exchange rate variations could have a significant impact on price developments, but not for the large euro area which represents a relatively closed economy.
- *Direct inflation targeting*: Monetary policy decisions would in this case be based on inflation forecasts relative to a pre-announced inflation target. Since the authorities lack

7) According to KING (1994), inflation targeting implies to employ inflation forecasts as intermediate targets.

8) SVENSSON (1999, p. 212f) maintains that the "Bundesbank has consistently given priority to the inflation target and disregarded the monetary target". "Thus, Bundesbank has actually been a monetary targeter in words only and an inflation targeter in deeds."

the instruments to directly steer the inflation rate, conditional inflation forecasts (conditional on different future paths of the policy instrument, using all information currently available) would assume the function of an intermediate policy target. The ECB also rejected this approach because (a) inflation forecasts were deemed an unreliable policy framework for identifying the risks to price stability, and (b) relying on the forecast of a single variable seemed too narrow an approach, given the diversity of the euro area economies.

The result of these considerations was the kind of *"implicit inflation targeting"*[9]) the ECB is pursuing now: There is, in quantitative terms, only a vaguely defined final target, no intermediate target which could be used as a nominal anchor, a monetary indicator which seems to have little bearing with regard to the final target, and an interest-rate instrument which must be precisely consistent with all this. When deciding on changes in short-term interest rates, the ESCB considers, besides direct impacts on inflation, also the transmission to the real sector. In the terminology of SVENSSON (1999), its strategy could therefore also be called "flexible inflation targeting"[10]).

When evaluating the strategy of the ESCB, one has to resort to criteria such as *efficiency* and *transparency*. BEGG et al. (1998) suggested that the ECB, for the sake of transparency, should follow an *instrument rule* (such as the Taylor rule) which would result in a reference value for short-term interest rates to be set by the ECB. However, setting a *targeting rule* (such as an inflation target) was considered to be eventually more efficient.

BRANDNER – SCHUBERTH (1999), taking up the arguments of BEGG et al., concluded that a *direct inflation target* would be efficient, but not transparent, as it lacked an explicit intermediate target. To be consistent, the reference value for money growth would have to be frequently adjusted, or large deviations of actual money growth from the reference value be accepted and explained to the public at large. Transparency could be achieved through publication of inflation forecasts which would serve as a substitute for an intermediate policy target.

In the *actual strategy* of the ESCB, the reference value for money growth is set to be consistent with price stability. The strategy is further characterised by the ECB refusing to communicate its inflation forecasts. Although this constitutes a lack of transparency, the ECB argues that concentrating on a specific staff forecast would neglect other information and analytical approaches available. Furthermore, and more importantly, if staff forecasts would

9) This term was used by BERNANKE – MISHKIN (1997, p. 99) to characterise the monetary strategy of the Bundesbank before joining EMU.

10) SVENSSON distinguishes "flexible inflation targeting" (when the loss function of the central bank contains not only an inflation target, but also the output gap as arguments) from "strict inflation targeting" (when the central bank is not concerned with stabilising the real economy).

be attributed an official touch, they would be prone, as indicated above, to become a source of speculation (ECB, 2001).

4. On the Road From Stability Import to Deflation?

How Restrictive Has the ESCB Been?

From an Austrian point of view, has the switch-over from HCP to EMU turned into a road from stability import to deflation? In other words, has the ESCB, since its inception in 1999, been *too restrictive* in its monetary policy? Some would spontaneously answer "yes", when judging the outcome by the unsatisfactory developments in the real sector, in particular by the growth rates of real GDP and employment or by unemployment rates.

However, to formulate a more sophisticated answer to this question would require to take account of the circumstances of policy decisions as well as the causal relationships between instruments in the monetary sector and real sector outcomes. The critique on the ECB has chiefly been based on *interest rate* developments in Europe compared with the USA, and the ECB has been blamed for reacting too little and too late to the weakening of economic activity in Europe (see, e. g., DE GRAUWE, 2002). This critique has not yet abated completely. Only recently, several Austrian politicians have claimed from the ECB to cut the "exorbitant" interest level in order to permit more speedy growth.

To judge the assertions that hold the ECB responsible for slow growth in Europe, one has to explore the following questions:

- Is there any firm causal connection between interest rates and economic growth (of consumption and investment in particular)? If yes, is it possible with the instruments of the ECB to steer those market interest rates that are relevant for the decisions of investors and consumers?
- Which were the options, under the given circumstances, of the ESCB to come up with alternative decisions?

Real Sector Effects of High Interest Rates

The first set of questions covers two dimensions, (a) the reaction of long-term interest rates on a change in short-term central bank rates, and (b) the interest elasticity of the demand for goods and services.

Interest rates in general are the result of *market forces*. The central bank plays some role in determining the interest level at the short end, and thereby influences the shape of the yield curve. However, it is not in a position to exert any significant impact on long-term interest rates which play, if any, only a minor role in determining the demand for consumer and investment goods. Above all, there are indications that *causality* may run both ways: market

interest rates are not only influenced by the central bank, but it can also happen vice versa: With some time lag, central banks often follow the developments in the market. Judged by the changing shapes of the yield curve, there is no uniform relationship between short- and long-term interest rates, although in "normal" times a positive slope can be assumed.

For sufficiently large changes in real interest rates, *real demand* will most likely react. Empirical estimates for Austria show, however, that the interest elasticity of investment and consumption demand is rather low, the main determinants being *non-price factors* (GNAN, 1994; PECH, 1994).

Currently, the interest level is anyway quite low in Europe, and, as revealed by the growth of M3, there is ample liquidity in the European economy. This may hint at a liquidity trap, implying that further monetary expansion would not contribute to economic growth. However, this does not render pointless the argument that the ESCB could have acted earlier and more decisively.

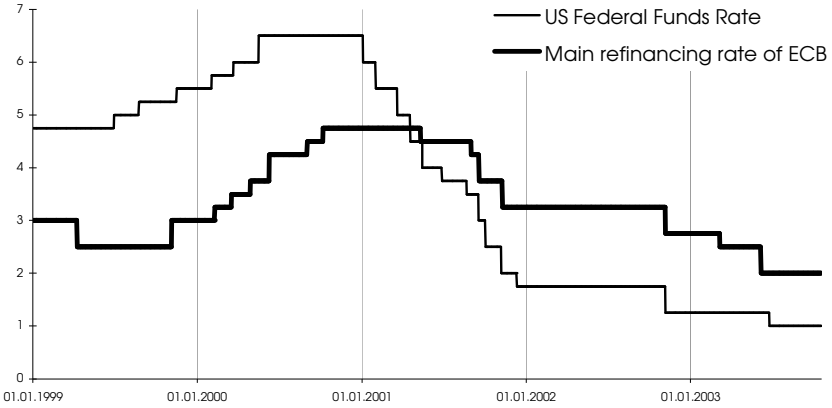
Policy Options of the ESCB

The policy options available must be discussed in view of the *circumstances* imposed upon the ESCB at the beginning of its existence in early 1999. The Asian crisis of late 1997 and the Russian crisis of summer 1998 were just overcome, and confidence in the world monetary system was still weak. The ECB started from scratch concerning its *credibility*, and it had no experience as to the effect on the development of monetary aggregates of Stage Three of EMU. The benchmark variable M3 expanded briskly in early 1999, well above the reference growth rate of 4.5%.

The major countervailing argument was the slowdown, in the second half of 1998, of the growth of real GDP. In spite of the rise in oil prises since February 1999, the ECB Governing Council decided on 8 April 1999 to lower its main refinancing rate from 3% to 2.5%. At this time, the Federal Funds rate in the USA amounted to 4.75%, and as from mid-1999 it was further increased in small steps, reaching a peak at 6.5% by May 2000.

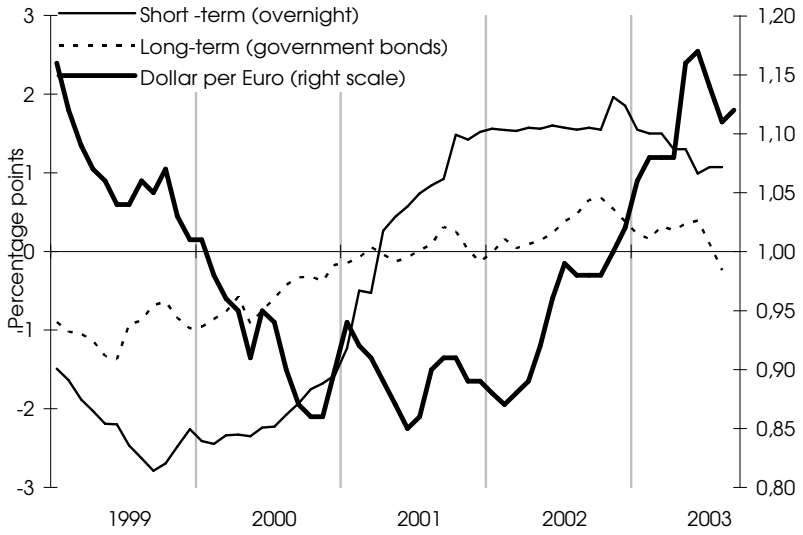
In the second half of 1999, a number of developments in Europe set the stage for a more restrictive stance of monetary policy: (a) the growth of monetary aggregates remained well above the reference value, (b) economic activity became more buoyant again, (c) oil prices continued to rise, putting an end to overall price stability, and (d) the nominal effective exchange rate of the euro, already on the decline since the last quarter of 1998, depreciated further. In particular, the dollar rate of the euro fell, and pressure from the general public mounted on the ECB to help maintain the external value of the euro. Thus, both pillars of the ECB's monetary strategy pointed at an increase in interest rates. Eventually, the main refinancing rate was raised to 3% on 4 November 1999. It was further stepped up to a peak at 4.75% in the last quarter of 2000. Overall, however, short-term interest rates from 1999 well into the year 2001 were lower in the Euro zone than in the United States (Figures 3 and 4).

Figure 3: ECB and Fed: Key Interest Rates



S: Federal Reserve Board, ECB.

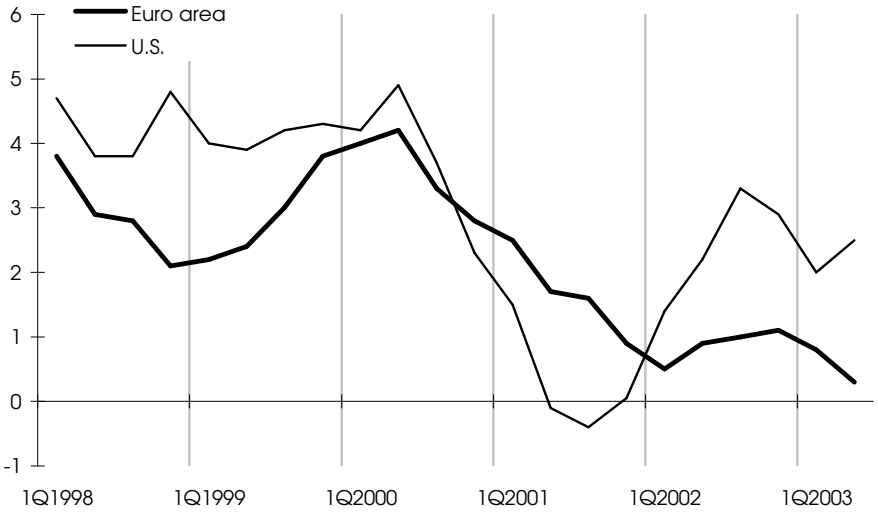
Figure 4: Exchange Rate versus Interest Rate Differentials Euro area – U.S.



S: OeNB.

The scene changed when in the first half of 2001 short-term US interest rates dropped below those in Europe, followed suit, though somewhat hesitantly, by long-term rates. In America, economic growth had already reached its peak in mid-year 2000, and a year later, the US economy was in recession (Figure 5).

Figure 5: Euro Area and US: Growth Rates of GDP
As percent

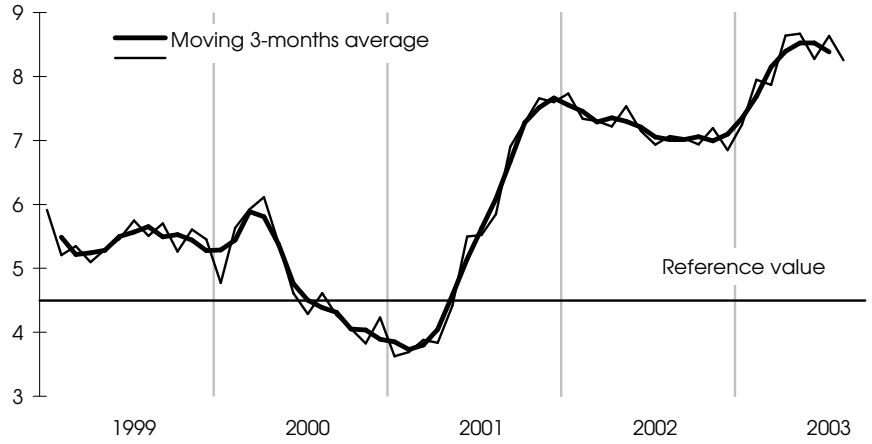


S: WIFO database.

Economic growth in Europe also dwindled in the second half of 2000, but did not become negative. At the same time, the growth of euro area M3 slowed down and dropped below the reference value, obviously reacting to the tightening of monetary policy. Although economic growth continued to weaken in the second half of 2001, M3 growth picked up sharply and has remained, since June 2001, significantly above the reference value – in the second half of 2003 at more than 8% (Figure 6). Although only regarded by the ECB as an indicator variable, M3 is still seen to provide important information on future inflation. Combined with the low dollar value of the euro, the ECB saw no other choice than retarding the drop in interest rates and thereby tailing the decline in US rates.

To sum up: Even in a strategy of "flexible inflation targeting", it is conceivable that the ESCB has been reluctant to have interest rates drop too sharply, particularly also given the pressure to restore the value of the euro against the dollar. In spite of these considerations, the main refinancing rate was lowered since May 2001 from 4.75% to 2% as of early June 2003.

Figure 6: Euro Area: Growth Rates of M3
Percentage changes against previous year



S: ECB.

At this stage, three sub-questions come up as to the success of monetary policy of the ECB:

- Should this success "only be gauged in terms of maintaining price stability" (ECB, 2001, p. 86), even when *price stability* also depends on the absence of external supply shocks (e.g. oil price hikes)? Even if inflation in the long run is regarded a purely monetary phenomenon, on the way thereto lengthy trade-offs with real sector developments may exist[11]).
- Why did the ECB not react earlier, as the Fed did in the USA, to the world-wide signs of a slowdown in economic activity? Apart from the rather modest trough in Europe, the Governing Council of the ECB was apparently determined to build up the *credibility* in the system by all means, including a reasonable dollar value of the euro. This is in line with the theory of *signalling* as earlier applied to the Austrian HCP (HOCHREITER – WINCKLER, 1992): When introducing a new policy regime, measures are often unduly harsh to set a proper signal.
- Why has the ECB not been more conclusive as to the role the *dollar exchange rate* plays in its monetary strategy? It would have been easy to communicate to the financial markets that the exchange rate is observed as an indicator of future inflation, but that

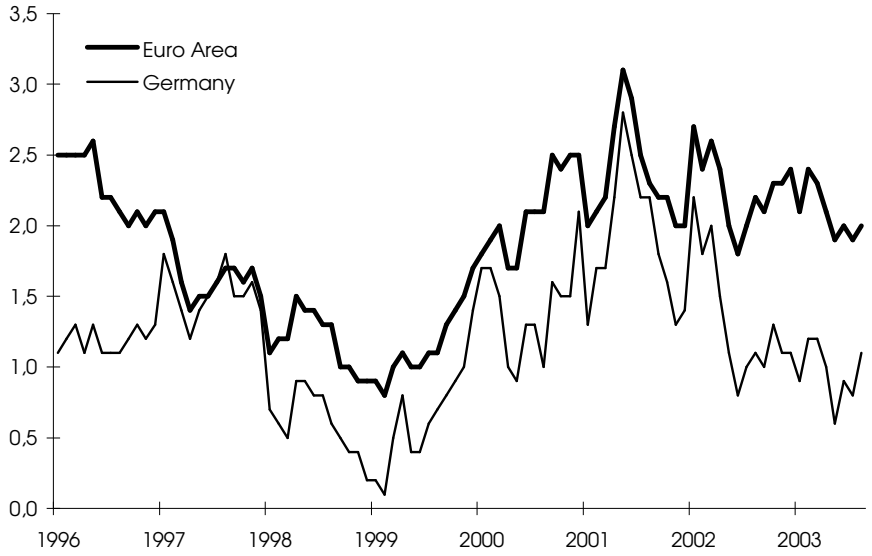
11) The discussion on the existence of a long-run Phillips curve in the euro area is far from being conclusive. Depending on the model, data selection and, above all, prejudice, the trade-off may be vertical (e. g., CLAUSEN – DONGES, 2001) or not (e. g., KARANASSOU – SALA – SNOWER, 2003).

there is no intention to counteract the market forces determining the exchange rate (i. e., it is not an intermediate monetary target).

Is Deflation Likely to Hit EMU?

There has been a discussion in Europe, which has not yet subsided completely, about the potential threat of deflation. Given the developments in Japan and low inflation in other parts of the world, ROGOFF (in KUMAR et al., 2003: v) states that *"central banks and monetary authorities are victims of their own success"*. In an international environment of slow growth and a trend towards more independent central banks, which are committed to price stability, an additional negative (demand) shock could easily induce a *vicious circle* with prices falling, accompanied by declining profits, outputs, employment and household real incomes. As a widespread phenomenon, deflation has not been heard of in industrial countries since the early 1930s.

Figure 7: Inflation in the Euro Area and in Germany
As percent



S: WIFO database.

In the *euro area* today, core inflation has not vanished altogether, and only *Germany* has been viewed as deflation-prone. Policy options are limited in Germany, given the large output gap, strains on the banking sector and the imminent necessity of fiscal consolidation. The Deutsche Bundesbank (2003), though, sees no imminent danger of deflation, and therefore only suggests to carefully watch the potential risks and to attach priority to structural reforms. In spite of virtual stagnation in Germany, some other indicators permit a rather

optimistic outlook concerning deflation: productivity and wages are on the rise, and prices are stable in the real estate sector. In addition, low inflation is partly the result of temporary phenomena, such as the euro appreciation against the dollar.

SVENSSON (1999) distinguishes *temporary deflation* (of a few quarters only and being expected to end soon) from a *"liquidity trap"* (persistent deflation over several years with ineffective monetary policy). Only the latter, which combines (approximately) zero interest rates with declining prices and deflation expectations, is of major concern: At interest rates close to zero, money in excess of transaction balances and bonds are perfect substitutes, and monetary policy becomes ineffective. Although deflation, like inflation, in theory may be neutral as to its real effects, in practice (e. g., because of insufficient downward flexibility of nominal prices and wages) it is likely to create instability and reduce real activity. In an alternative ("monetarist") model of the transmission mechanism, the demand for money depends on the yields of a variety of assets which are not perfect substitutes. Money expansion would then affect relative asset prices, which in turn would have a positive impact on spending. There would be no liquidity trap (KING, 1999).

To *avoid a liquidity trap*, SVENSSON (1999) suggests that the central bank watch out, as under inflation targeting, on the development of actual inflation and of inflation expectations. He regards an explicit inflation target of 2% as providing ample margin to avoid a liquidity trap. MELTZER (1999) concurs with the view that "(z)ero inflation raises no major obstacle to monetary control" as long as "all assets are not perfect substitutes" (p. 272f). KUMAR et al. (2003) stress the importance of pre-emptive and forceful measures to ward off deflation, with monetary policy taking the lead and being supplemented by expansionary fiscal policy and structural reforms. Thus, to be successful economic policy should not be constrained by too many other policy goals.

Overall, there seems to be no immediate threat that low inflation (which is the goal of inflation targeting) could easily tilt into deflation. With the successes of inflation targeting it may become inevitable, however, to increase the flexibility of the target to also account for potential real sector slumps. ECB policies have been in line with this demand, in particular by re-interpreting price stability as the "aim to maintain inflation rates close to 2% over the medium term" (ECB 2003).

5. Summary

The main arguments put forward in this essay may be summarised as follows:

For Austria, the HCP was a success in achieving price stability, and it served as a training camp for later EMU membership. Under both regimes, though conducted under different institutional settings, final monetary policy targets were similar and adjustment needs in the real sector comparable.

Some of the virtues of the hard currency era, such as transparency and credibility, which in Austria took many years to establish, are still to be developed in EMU.

The monetary strategy of the ESCB deliberately lacks an intermediate monetary target, and even the final goal is not precisely defined. This makes it easier for the ECB to forego public justification of its policy. However, it also challenges transparency which is a precondition of credibility and, given the high degree of independence of the ESCB, of accountability vis-à-vis the general public.

Since M3 is not considered by the ECB as a target variable, its prominent role within the monetary strategy could be downgraded.

Given the obvious success of the ESCB in achieving and maintaining price stability, deflation has become a potential threat, and this may require somewhat greater flexibility in pursuing the final target.

Many of the issues addressed by Georg Winckler with regard to the hard currency era, such as transparency and credibility, remain valid also in EMU.

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