The ECB's Monetary Policy Strategy: Why did we choose a two Pillar Approach?

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1. The truth about the term

The title of my paper makes it perfectly clear: we are talking about history. This emphasis is appropriate. Otherwise colleagues at the ECB might have told me: Otmar, you are history. This reminds of the dictum that progress in science comes funeral by funeral or in institutions fortunately rather retirement by retirement.
Nevertheless, nobody will protest if I place the decision of 1998 on the strategy of the ECB into a broader context. Therefore, I will comment - with different emphasis - on three questions.

1) What were the reasons for this decision, and was the choice of strategy appropriate at that time?
2) Has the strategy served the ECB well since?
3) Is the strategy robust and flexible enough to fit a changing economy and progress in research?

Before I come back to these questions, let me be precise on history. To be frank, at first in our communication we did not exactly speak of a "two pillar approach". (In internal discussions we had already used the term "pillar". We had initially identified three pillars, the third one being the quantitative definition of price stability.) The public use of this term goes back to the press conference of 13 October 1998 in which the president communicated the adoption of "A stability-oriented monetary policy strategy for the ESCB" by the Governing Council. Then a journalist asked: "I have a question about your monetary policy strategy regarding the *dual pillars of the strategy* the monetary element and the inflation forecast or real economy element. Will they carry approximately equal weights or will you decide the relative weighting between the two pillars on a case by case basis?" (By the way this is not only evidence for the intelligence of the journalist but also for the successful communication of the ECB right from the beginning.) Wim Duisenberg answered:"…it is not a coincidence that I have used the words that money will play a prominent role. So if you call it the *two pillars*, one pillar is thicker than the other is, or stronger than the other, but how much I couldn't tell you."

When I discussed this wording with my experts a few days later the opinions were split if we should adopt it or not. The arguments brought forward reflected already the experience we made later. On the one hand, the notion of "two pillars" could give the impression of a split of analysis and arguments thereby contributing to confusion. On the other hand this term makes not only clear that the ECB´s approach has a characteristic which is specific, it has also the charm of signalling, in a shortcut, a rock solid approach. So, it is not surprising that soon it became a kind of trademark notwithstanding the fact that the initial disadvantages of the term remained valid for some time to come.

2. A situation of extreme uncertainty

After the establishment of the ECB on 1 June 1998, only 7 months were left to prepare for the beginning of monetary policy for the euro area. As a result of long discussions among the experts from the EMI two options had "survived," namely

monetary targeting and inflation targeting. Years before – during my term at the Bundesbank - I had initially argued in favour of the ECB adopting monetary targeting but had at a later stage already signalled reservations (Issing, 1998b).
But now we had to come to a final conclusion and decision. Monetary policy always has to be conducted under uncertainty, but it was obvious that we were confronted with a situation of extreme uncertainty. It is instructive to review all the elements of uncertainty in some detail (see also Issing, 2002).

- First, there was uncertainty about the state of the economy. Needless to say that the data situation around the start in January 1999– and, though gradually improving, for years to come - was very worrisome. This was true for simple data but even more for unobservable indicators like the output gap etc. In this context it would also be extremely difficult to identify the nature and persistence of potential shocks.

- Secondly, uncertainty concerned the structure and functioning of the economy. This uncertainty has two sources. First, there is a fundamental uncertainty as to which models provide the most reasonable description of the functioning of the economy – and how they relate to each other. Second, this uncertainty depends on the strength and stability of the structural relationships, the so-called parameter uncertainty. Here, the famous Lucas Critique was especially relevant, as all countries preparing for participation in EMU underwent a deep structural change which might even intensify after entry into the regime of a single currency.

- Finally, we faced a situation of strategic uncertainty, i.e. uncertainty over our own interaction with private agents. The impact of monetary policy on the economy depends to a large extent on the formation of expectations by private agents. How would markets, investors and consumers/savers react to the disappearance of the familiar national currencies and the introduction of a new one, the euro? This kind of uncertainty has an endogenous character insofar as its degree would very much depend on the way the new central bank would be able to master the situation. Strategic uncertainty highlights the need to anchor expectations quickly. From this it is evident that continuity with the best performers of national central banks participating in monetary union and especially with the Bundesbank had to be given high priority.

3. The choice of a Strategy

After the thorough assessment of the situation the challenge was how to deal with this historically unique situation. (On the issue of monetary policy in uncharted territory see Issing, 2003b, and Issing et al. 2006). In the spirit of full transparency should the ECB not just start in a process of trial and error under the motto: trust us, we will do our best to fulfil our mandate of maintaining price stability?

Spelling out this option means already to discard it. How could a brand new institution like the ECB convince the public of its determination to maintain price stability just by announcing a “let’s do it approach”? Such an option is only viable ex post, when credibility derives from a solid track record. Therefore this option was not available for the ECB before and at the start. Such an approach would have also missed the chance to transfer credibility from the "old" national central banks to the new one, the ECB.

A strategy was needed! But, what kind of strategy? Would it not be advisable just to emulate the example of the Bundesbank and adopt a strategy of monetary targeting? For me the arguments against such a choice were straightforward. I had experience of rather wild volatility of M3 in the nineties and I knew how difficult it was to explain to the public-and sometimes even to the Zentralbankrat- that we should nevertheless stick to our strategy of monetary targeting? I also knew that aggregate euro area M3 could display a similar degree of volatility. How could we hope to explain convincingly to the public that this should be interpreted as a temporary phenomenon? Wasn't the disappearance of long established currencies and central banks and the arrival of a new money and a new institution responsible for it a regime shift of extreme dimension- with a very high risk of structural breaks in the meaning of the Lucas critique? Under those circumstances, how could we maintain consensus among the members of the Governing Council, who anyway had different priors as to the role of money?
In case the ECB would have to abandon a strategy soon after the start this would cause an almost deadly blow to the credibility of the new institution from which it would not recover for years.
So, monetary targeting was excluded as an option. However, rejecting monetary targeting as a strategy for the ECB did of course not imply neglecting the overwhelming evidence for the long-run relation between money and prices and the undeniable fact that monetary policy has somewhat to do with "money".

Inflation targeting could also not cope with the challenges we were confronted with. There has been and there is still some confusion on the terminology. The ECB has quantified its target for maintaining price stability and made it public. If a quantified target for keeping inflation low is the relevant criterion, the ECB is indeed an inflation targeter (Issing 2003c). However, the relevant interpretation of this monetary policy strategy here is that of inflation *forecast* targeting. It is obvious that the "beauty" of this approach fully depends on the reliability of the inflation forecast as **the** fundament for the conduct of monetary policy. But no forecast is a sufficient summary of information. And in the specific case of the start of monetary union none of the supporters of the option of inflation targeting ever tried to explain how we could rely on any inflation forecast considering the uncertainties mentioned before. (I am still puzzled by the way how e.g. the rather extreme divergencies of estimates for the output gap by different institutions and later revisions are just ignored.) Above all, it is obvious that an inflation forecast targeting approach would not be able to integrate the information stemming from monetary developments to identify risks to price stability over the medium- to long-term. Adopting inflation targeting would therefore have unduly shortened the horizon of monetary policy to the conventional forecast horizon of one to two years.

To cut a long story short the starting point for me was: we needed a strategy, and money should be given a "prominent" role within such a strategy. The challenge now was how to create an all-encompassing strategy so that no relevant information was lost and which at the same time would structure all incoming data in a way that we would be able to identify risks to price stability in a timely and consistent manner. Transparency about our strategy was also an important element which guided our deliberations. As a consequence the ECB made its strategy public already before the start. The first Monthly Bulletin of the ECB included an article on the strategy (ECB 1999).

May I also mention in this context that hardly any other central bank has documented the process of creating a strategy in almost real time (Issing et al., 2001). It might be interesting to quote: "To summarise, no simple and unique indicator has proven sufficient for central banks to motivate and explain their policy decisions In spite of the rigidity of theoretical monetary targeting and inflation targeting, judgment has been a crucial element of both monetary policy strategies.

Taking stock of these experiences, one of the key characteristics of the ECB`s new monetary policy strategy-conceived in order to cope with the particularly high degree of uncertainty and imperfect knowledge at the beginning of Stage Three of EMU-is to acknowledge explicitly the lack of satisfactory models suitable for policy analysis" (p.104/5).

Finally, an explicit strategy was also needed for a reason which is mostly overlooked in public. The responsibility for the conduct of monetary policy would be transferred to the Governing Council, a complex committee of highly qualified persons, 11 governors coming from longstanding central banks. How to prepare these meetings, how to guarantee that all deliberations would be concentrated on the euro area, on the risks to price stability for the single currency?

Already the internal discussion before the start demonstrated that an explicit strategy was needed to structure the documents preparing the meetings and to organise the discussions. Experience soon has shown that the chosen strategy has worked extremely well also in this respect. It has facilitated an open and frank exchange of views with a strong focus on the final goal, namely the ECB's mandate to maintain price stability in the euro area as a whole over the medium term.

4. The two pillars

In October 1998, the Governing Council adopted its stability oriented monetary policy strategy with three elements namely

- a quantitative definition of price stability;

- a prominent role for money;

- a broadly based assessment of the outlook for future price developments.

In its first Monthly Bulletin of January 1999 (ECB, 1999), the ECB published an article explaining its strategy in detail. By the way, in this publication the ECB also adopted officially the term of "two pillars". (See also ECB, 2000).

"Inflation is ultimately a monetary phenomenon" – this is the starting point why money should be given a prominent role. To establish a kind of quantitative benchmark for identifying longer-term risks to price stability the ECB derived a reference value but made immediately clear that any deviation of M3 growth would not trigger a mechanistic monetary policy reaction but would prompt further analysis to identify the reasons behind such developments. The ECB already made clear that other monetary aggregates etc. would also have to be assessed thoroughly.

To quote from the Bulletin (p.49):”Although the monetary data contain information vital to informed monetary policy-making, on their own they will not constitute a complete summary of all the information about the economy required to set an appropriate monetary policy for the maintenance of price stability. Therefore, in parallel with the analysis of money growth in relation to the reference value, a broadly based assessment of the outlook for price developments and the risks to price stability in the euro area will play a major role in the Eurosystem`s strategy. This assessment will be made using a wide range of economic indicators”.

It was clear from the beginning that risks to price stability identified under the two pillars referred to different time horizons. The relation between “money” and prices is a long run phenomenon and short-term movements in monetary data do not necessarily give an indication on the need for policy actions. On the other hand, limiting the horizon of monetary policy to the information coming from the economic analysis would run the risk of conducting a short term oriented and “activist” monetary policy loosing side of trend developments. Money is therefore a kind of “natural” anchor for the longer term orientation of monetary policy.

This choice of two pillars was seen as a device to structure the information coming from a host of data which would be conducive for the internal discussion as well as for the communication (Issing, 2003a).

Monetary policy has its full impact on the economy only with long time lags. The Governing Council as the decision making body has to take into account all information when coming to its policy decisions, thereby ensuring that the long- to medium-term orientation does not get out of sight. The monetary pillar should help to look beyond the transient impact of various shocks, protecting against the temptation of fine-tuning the economy and maintaining a firm medium- to long-term orientation.

The two pillars serve the purpose of organising the incoming data in a structured way basically under the aspect of the relevant time horizon. The cross-checking is a means of reconciling the shorter-term analysis with the longer-term perspective leading to a consistent, “unified” overall assessment. “Two pillars, a single framework” a headline in our book of 2001 captures the message we wanted to give and the reasoning behind it.

5. Real-time assessment versus ex-post rationalisation

In the press release of 8 May 2003 on the result of the evaluation of the strategy the Governing Council stated: ”More than four years of implementation have worked quite successfully”. I would be surprised if nowadays i.e. eight years after the adoption of the strategy an assessment would sound differently.

This and the fact that the monetary policy of the ECB in general gets high marks can be seen as evidence that the Governing Council back in 1998 took the right decision when choosing its stability oriented monetary policy strategy. Of course, one could still argue that another strategy would have delivered the same –or even better?- results. I leave this counterfactual thought-experiment to others.

It is, however much more convenient to argue on the basis of success and I cannot hide satisfaction against the background of so much criticism especially around the start of our policy. There is no need – and even no chance - of ex-post rationalisation of our decision of 1998 as we have been so transparent on the concept as such as well on the details. Considering J. M. Keynes' observation that "worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally" (Keynes, 1936, Chapter 12, V) the ECB took a high risk not joining the then dominant approach of inflation targeting.

This is not the place to analyse the monetary policy of the ECB since the start until to-day (see e.g. Issing, 2005). The interpretation of information from the monetary pillar sometimes has been anything but simple not least because of substantial portfolio shifts (for a thorough analysis, see Fischer et al., 2006). But, this is not to say that economic analysis on balance "did better" or even "standing alone" could have given complete and consistent guidance to the ECB for maintaining price stability over the medium-term. Overall, the strategy with its two pillars and appropriate cross-checking provided a robust approach on the basis of which the ECB could –considering major shocks during this period- conduct a surprisingly smooth and successful monetary policy (Gaspar and Kashyap, 2006). (On the role of crosschecking see also a recent paper by Beck and Wieland., 2006.)

6. Future prospects?

The most remarkable element of the ECB's strategy which makes it unique was the importance given to "money". I have already provided the arguments for this decision. At that time, perhaps neglect of money was at its peak not only in central banking. "Money" had almost disappeared from macroeconomics. This is not a new phenomenon. The fifties of the last century were dominated by the view "that money doesn't matter" before the world in the great inflation of the seventies had to learn that neglect of money might not be a wise choice. (For evidence that taking monetary developments serious helps to avoid high inflation see Issing, 2005a). The monetarist revolution was very much supported by this experience.

It is not surprising that in a world of low inflation the interest in "money" in central banks as well as in academia has declined, if not disappeared. I do, however hope that the world does not have to go through the same process of pathological learning as at the end of the last century. From an intellectual point of view I would like to ask those who disregard money if it is not premature –or should we say just arrogant–to claim that all this evidence collected over many centuries and across numerous countries has lost any meaning for the present and the future? Can one really expect that models without an explicit, well developed financial sector can explain an economic world in which financial markets play an ever increasing role? And, how could a central bank which conducts a monetary policy in which these financial markets are essential for the transmission mechanism rely on such models?

We do not know what will happen in the future. Will financial innovations, new financial institutions, cashless payments, electronic money dominate in a way that any experience from the past as to the relation between present monetary aggregates and prices will become obsolete? Nobody knows. But, it may be worthwhile remembering that in the 19th century we saw a comparable development in practice and an accompanying discussion between representatives of Banking and Currency Schools.

A central bank should also in this respect be on the side of caution. I wonder if the figure of the “conservative central banker” used in the economic literature should not be accompanied by an element of intellectual conservatism. This is not an argument in favour of ignoring new research and discussions in academia. Not at all! But, we have also seen a kind of renaissance of the role of money as was demonstrated e.g. by a number of contributions at the ECB’s Colloquium in March this year.

From this perspective one might argue that the ECB with its choice of strategy was ahead of developments- a notion of which I was convinced from the start. I would also like to refer to a speech given by the governor of the Bank of England Mervyn King with the title “No money, no inflation” which gave a clear message(King, 2002).

In the meantime the importance of money (and credit) has been (re-)discovered in an already impressive number of contributions. One strand of research focuses on the global dimension (Bordo and Filardo, 2006; Ciccarelli and Mojon, 2006: Mumtaz and Surico, 2006). Another important field of research analyses the relation between money and credit and asset prices (Adalid and Detken, 2006; Detken and Smets, 2004, and a number of studies at the BIS by Claudio Borio and others). Finally, I would also like to draw the attention to the contributions by Larry Christiano in cooperation with Roberto Motto and Massimo Rostagno (Christiano et al, 2003, 2006).

This leaves open the question if a separate monetary pillar is the definitive answer to these challenges. But, as long as we lack a model which encompasses both dimensions, the economic or real and the monetary, in a consistent manner, I am not aware of a superior approach. We might have to wait still quite some time before this task of –if you wish- establishing the conceptual and empirical background for a “one-pillar-approach” is achieved. Nobody would be happier than me if we could celebrate success in this endeavour rather sooner than later (see Issing, 2006).

It is hard to believe that any central bank would totally ignore the information coming from “money” although it is sometimes difficult to discover how this information enters the process of analysis and decision. Establishing a monetary pillar means creating a strong barrier against the risk of just “forgetting” money. To say it in a phrase coined By Larry Christiano at this conference it guarantees that money has always a seat at the table. Looking back into 1998 the monetary pillar can be seen as a lighthouse signalling that money should never be ignored -neither in monetary policy nor in research. This conference confirms that the ECB has transferred this awareness into the twenty-first century.

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