



# ECB Observer

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*Analyses of the monetary policy of  
the System of European Central Banks*

## **Back to the rules**

**No 8**

**27 September 2005**

**Ansgar Belke**

**Wim Kösters**

**Martin Leschke**

**Thorsten Polleit**

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## SUMMARY

### Part 1

#### Rules for sound money

Under today's paper money standard, the political independency of central banks' monetary policies and the objective to keep inflation at a low and stable level are widely seen as proper guarantees for preserving the value of the currency. At the same time, however, "rule binding" of monetary policy action has been on the decline in recent years; "discretion" has been on the rise. As a result, the value of money increasingly depends on the "competence" of monetary policy makers. However, policy discretion will inevitably entail the risk of "human error". The hope that desired objectives can be met through deliberate and careful policy making by experts seems to increasingly outweigh concerns that the cost of policy errors under a system of discretion might become prohibitively high. We think that too little is known about the remoter effects of an ad hoc monetary policy that could support the latest trend towards returning to discretion in central banking. We therefore express concern that in particular money and credit expansion has been increasingly losing importance in putting limits to today's "state-of-the-art" monetary policy making.

### Part 2

#### How the ECB and the US Fed set interest rates

Monetary policies of the ECB and US Fed can be characterised by "Taylor rules", that is both central banks seem to be setting rates by taking into account the "output gap" and inflation. (We also set up and tested Taylor rules which incorporate money growth and the change in the nominal exchange rate, thereby improving the "fit" between actual and Taylor rule based rates.) In general, Taylor rules appear to be a much better way of describing Fed policy than ECB policy. The finding that Taylor rules "hold", however, is by no means a sign of a "good quality policy": it merely shows that both central banks seem to pursue a cyclical rather than medium- to long-term-oriented monetary policy (thereby becoming a potential source of economic disruptions); responding to, rather than preventing, target deviations seems to be the underlying rationale. Moreover, our simulations suggest that the ECB's short-term interest rates have been at a much lower level in the last two years compared with what a Taylor rule would suggest. This finding corresponds to our analysis that the bank's monetary policy stance is currently very expansionary indeed by all "standard measures".

### Part 3

#### A call for publishing ECB Governing Council minutes

By publishing Governing Council meeting minutes, the ECB could improve the transparency and efficiency of its monetary policy substantially, thereby supporting its stability-oriented course for at least two reasons. First, publishing minutes should induce a positive disciplinary incentive for (i) improving the quality of the internal discussion among Council members and (ii) counteracting any inclination on the part of Council members to deviate from a

euro-wide oriented monetary policy. Second, minutes should help keeping a better balance of “influence power” between ECB Executive Board members and NCB presidents compared to the current status quo. The rationale for publishing minutes should increase in view of the foreseeable extension of the Governing Council due to the Eastward extension of the euro area and the envisaged reform of the Council’s voting modalities. To be sure: ECB Governing Council meeting minutes shall not necessarily attribute names to individual statement made in Council meetings; they shall serve to explain the ECB Council’s thinking, debate and decision to the outside world.

#### **Part 4**

#### **ECB monetary policy and euro inflation outlook**

The inflation outlook in the euro area has deteriorated compared to our May 2005 forecast. Monetary policy appears too expansionary according to all standard measures, especially so against the backdrop of the “energy price shock”. We estimate that annual inflation in 2006 will be 2.5% (excluding “special factors”) with little signs that inflation will fall back to below the ECB’s 2% upper ceiling anytime soon. The ECB would thus be well advised to bring interest rates back towards a more “neutral level” which we think is in the neighbourhood of 3.5%. – Looking at the relation between money growth and inflation in the US, the euro area and Japan, money expansion and price rises appear, over the long-run, closely related. The more recent findings of an alleged “weakening” of this relation might be explained by “excess money” increasingly inflating asset rather than consumer prices. However, asset price inflation would certainly be no less detrimental to the purchasing power of money compared with “traditional” consumer price inflation – and therefore monetary policy should not disregard asset price inflation when setting rates, in our view. The growth rates of money should be interpreted as a valuable guide for monetary policy makers.



## Zusammenfassung

### Teil 1

#### Regeln für stabiles Geld

Die Institutionen, die den Erfolg des Papiergeldstandards garantieren sollen, sind die politische Unabhängigkeit der Zentralbank und die Zielvorgabe, die Inflation niedrig zu halten. Gleichzeitig hat in den letzten Jahren die „Regelbindung“ der Geldpolitik immer weiter zu Lasten diskretionären Handelns abgenommen. Damit hängt der Geldwert nun ganz entscheidend von der Handlungskompetenz/„Expertise“ der Zentralbanker ab. Die Diskretion der Geldpolitik birgt jedoch das Risiko menschlicher Fehler/Irrtümer. Die Hoffnung, dass ein vorgegebenes Inflationsziel durch wohlüberlegtes fallweises Handeln zu erreichen ist, scheint zunehmend die Sorge vor den (mitunter prohibitiv hohen) Kosten von Politikfehlern zu überlagern. Allerdings ist das Wissen über die (weiter in die Zukunft reichenden) Folgen eines ad hoc Handelns zu gering, als dass eine (Trend)Rückkehr zu einer diskretionären Geldpolitik zu rechtfertigen wäre. Insbesondere muss besorgt stimmen, dass der Geld- und Kreditmengenexpansion immer weniger Bedeutung zugewiesen wird, wenn es darum geht, die Grenzen der Zinspolitiken der Notenbanken zu bestimmen.

### Teil 2

#### Zinssetzungsverhalten der EZB und der US Fed

Die Zinspolitiken der EZB und der US Fed können recht gut anhand von „Taylor-Regeln“ beschrieben werden, d. h. beide Zentralbanken reagieren auf die „Outputlücke“ und die laufende Inflation. Wir haben ebenfalls Taylor-Regeln spezifiziert und getestet, die das Geldmengenwachstum und den effektiven Wechselkurs berücksichtigen; sie verbessern den „Fit“ zwischen aktuellem und theoretischem Taylorzins. Taylor-Regeln erklären dabei das Zinssetzungsverhalten der Fed generell besser als das der EZB. Der Befund, dass die Taylor-Regeln „halten“, ist jedoch keinesfalls ein Gütezeichen für die Geldpolitiken. Er zeigt vielmehr, dass die Notenbank recht zyklisch und damit weniger mittel- bis langfristorientiert die Zinsen setzen – und möglicherweise dadurch selbst Quelle für Störungen im Wirtschaftsablauf werden. Eher auf Zielabweichungen zu reagieren, als sie vorausschauend zu vermeiden, scheint das unterliegende Geldpolitik-Verhalten zu charakterisieren. Unsere Simulationen deuten an, dass der EZB-Zins in den letzten zwei Jahren deutlich niedriger gewesen ist, als es die Taylor-Regel nahe legen würde. Dieser Befund unterstreicht unsere (bisherigen) Analyseergebnisse, dass nämlich die EZB-Geldpolitik nach wie vor zu expansiv ist.

### Teil 3

#### EZB sollte Sitzungsprotokolle veröffentlichen

Die Pressemitteilung der EZB erlaubt es Außenstehenden nicht, sich ein angemessenes Bild über die geldpolitische Debatte im Rat zu verschaffen. Die EZB könnte die Transparenz ihrer Politik substantiell erhöhen, wenn sie Sitzungsprotokolle – etwa nach dem Muster der US Fed und der Bank of England – veröffentlichen würde. Dies würde die stabilitätsorientierte Politik

der Bank unterstützen. Zum einen würde die Veröffentlichung von Sitzungsprotokollen die Ratsmitglieder disziplinieren, die Qualität der geldpolitischen Diskussion ständig weiter zu erhöhen, und sie würde die Neigungen einzelner Mitglieder entgegenwirken, von der „Euroraum-weiten“ Betrachtung in nationales Denken und Entscheiden abzuweichen. Zum anderen dürfte das Veröffentlichen von Sitzungsprotokollen – verglichen mit den Status quo – zu einer besseren „Balance der Einflussmacht“ zwischen EZB-Direktorium und den nationalen Notenbankpräsidenten verhelfen. Die Ratio für das Veröffentlichen von Sitzungsprotokollen steigt weiter an angesichts der Erweiterung des EZB-Rates im Zuge der anstehenden Osterweiterung des Währungsraums. Es sei betont: Sitzungsprotokolle müssen nicht notwendigerweise die Diskussionsbeiträge der Ratsmitglieder preisgeben; sie sollen die Öffentlichkeit aber über Inhalt, Debatte und Entscheidung der Geldpolitik EZB-Rat informieren.

#### Teil 4

#### **EZB-Geldpolitik und Inflationsausblick**

Der Inflationsausblick im Euroraum hat sich gegenüber der Schätzung im Mai 2005 verschlechtert. Gemäß allen „Standardmaßen“ erscheint die Geldpolitik der EZB zu expansiv, insbesondere vor dem Hintergrund des „Energiepreisschocks“. Wir schätzen, dass die jahresdurchschnittliche Inflation in 2006 auf 2,5% ansteigt (ohne Berücksichtigung von „Spezialfaktoren“). Es ist derzeit nicht abzusehen, dass die Inflation wieder unter die 2-Prozentmarke fällt. Es ist der EZB daher nahe zu legen, den Notenbankzins in Richtung eines eher „neutralen“ Niveaus, das wir auf etwa 3,5% beziffern, anzuheben. – Eine Betrachtung der Beziehung zwischen Geldmengenwachstum und Inflation in den USA, dem Euroraum und Japan zeigt über die lange Frist einen rechten engen Zusammenhang beider Größen. Die jüngsten Befunde, dass sich diese Beziehung gelockert zu haben scheint, könnten damit begründet werden, dass die „Überschussgeldmengen“ aktuell weniger die Konsumentenpreise in die Höhe treiben als vielmehr die Preise für Bestandsvermögen. Eine „Asset Price Inflation“ wäre jedoch genauso schädlich für die Kaufkraft des Geldes wie die „traditionelle“ Konsumentenpreis-inflation. Die Notenbanken sollten daher Asset Price Inflation bei ihrer Geldpolitik berücksichtigen. Die Wachstumsraten der Geldmengen dürften dabei helfen, die richtige Zinspolitik zu verfolgen.



## Appendix



## APPENDIX

<b>A.3. – ECB OBSERVER – recent publications</b>		
<b>Number</b>	<b>Title and content</b>	<b>Date of publication</b>
No. 8	Back to the rules Content: 1. Rules for sound money. – 2. How the ECB and the US Fed set interest rates. – 3. A call for ECB Governing Council minutes. – 4. Euro area monetary policy and inflation outlook.	27 September 2005
No. 7	Towards a “more neutral” monetary policy Content: 1. A critical look at ECB staff inflation projections. – 2. Asset price inflation – a cause of concern for monetary policy. – 3. Impact of short-term rates on stock market returns. – 4. ECB rate and euro inflation outlook.	16 September 2004
No. 6	Liquidity on the rise Content: 1. A case against ECB FX market interventions. – 2. “Price gaps” and US inflation. – 3. “Price gaps” and euro area inflation. – 4. ECB rate and euro inflation outlook.	2 February 2004
No. 5	Challenges to ECB credibility Content: 1. Fundamentals of ECB credibility. – 2. ECB strategy review – increasing the bank's open flank. – 3. Uncertainty – pressure for easier monetary policy. – 4. ECB policy review and outlook.	8 July 2003
No. 4	International coordination of monetary policies – challenges, concepts and consequences Content: 1. International coordination of monetary policies. – 2. Does the ECB follow the Fed? – 3. Stock prices – a special challenge for monetary policy. – 4. ECB monetary policy review and outlook.	19 December 2002
No. 3	The Fed and the ECB – why and how policies differ Content: 1. The US Federal Reserve System and the European System of Central Banks – selected issues under review. – 2. The reaction functions of the US Fed and ECB. – 3. The influence of monetary policy on consumer prices. – 4. ECB rate policy and euro area inflation perspectives.	24 June 2002
No. 2	Can the ECB do more for growth? Content: 1. Should the ECB assign a greater role to growth? – 2. Government finances and ECB policy – a discussion of the European Stability and Growth Pact. – 3. “Price gap” versus reference value concept. – 4. Assessment of current ECB policy and outlook.	19 November 2001
No. 1	Inflationsperspektiven im Euro-Raum Content: 1. Warum die EZB-Geldpolitik glaubwürdig ist. – 2. EZB-Strategie – Stabilitätsgarant oder überkommenes Regelwerk? – 3. Stabilitätsrisiken der Osterweiterung. – 4. Zinspolitik der EZB in 2001 und 2002.	17 April 2001

## APPENDIX

**A.4. – ECB OBSERVER – *objectives and approach***

The objective of ECB Observer is to analyse and comment on the conceptual and operational monetary policy of the European System of Central Banks (ESCB). ECB Observer analyses focus on the potential consequences of past and current monetary policy actions for the future real and monetary environment in the euro area. The analyses aim to take into account insights from monetary policy theory, institutional economics and capital market theory and are supplemented by quantitative methods. The results of the analyses are made public to a broad audience with the aim of strengthening and improving interest in and understanding of ECB monetary policy. ECB publishes its analyses in written form on a semi-annual basis.

## A.5. – ECB OBSERVER – *team members*

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