

Central Banking: Art or Science? Lessons from the Fed and the ECB”

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A Review of

- Issing, O., Gaspar, V., Angeloni, I., Tristani, O., *Monetary Policy in the Euro Area, Strategy and Decision-Making at the European Central Bank*, Cambridge University Press, Cambridge, 2001, 199pp.
 - Woodward, B., *Maestro: Greenspan's Fed and the American Boom*, Simon & Schuster, 2000, 270 pp.
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Never has central banking been more subjected to scientific analysis than during the last two decades. Increasingly, the economic profession has moulded the behaviour of the central banker into abstract economic models. This has made it possible to analyse how the central banker can be given incentives that will make him do the right thing, how he should set interest rates optimally, how he should be made accountable and what his punishment should be if he fails to comply to the terms of his contract. And yet, after the scientific onslaught of the last decades there is still this feeling that after all, central banking is mainly an art, and that the success of a central banker depends on such intangibles as feeling the mood of the market.

The scientific and the artistic views of central banking are well represented by two recently published books. The first one tells us the saga of Greenspan. Written by the best-selling author Bob Woodward, it presents us with a novel-like account of how Greenspan contributed to the miracle of the new economy in the US. This book is about the art of central banking.

At the other extreme there is a remarkable book of Otmar Issing and his collaborators at the European Central Bank that presents us with an insightful survey of the state of the science of central banking, and how the ECB policies fit into this scientific picture. Despite its emphasis on scientific analysis of central banking, it warns us regularly that the mathematical models must be supplemented by ‘judgment’. Scientific analysis must be combined with artistic feeling to produce a successful central banker.

How does one measure success in central banking? The answer to this question lies at the centre of the debate among economists about what a central bank should do, and thus what the area of his responsibility should be. The answer given by Woodward is that Greenspan's towering success was due not only to the fact that he kept US inflation low, but also, and probably in the first place, because he recognised the great potential of the American productivity growth 'miracle' of the second half of the 1990s and buttressed it with easy money. As a result, he helped to create the American productivity miracle. Thus, in this view successful central bankers not only keep inflation low (a necessary condition to stay in the premier league of top central bankers) but also contribute to economic prosperity.

The view one gets from reading Otmar Issing and his associates' guide to central banking could not be more different. Steeped in the German tradition of central banking, the view presented in this book is quite clear. Price stability is the only serious objective the central bank should be concerned about. The Maastricht Treaty which has formulated the mandate of the ECB is more subtle though. While it recognizes that price stability is the primary objective of central banking, it adds that when price stability is not endangered, the central bank should also be concerned about other objectives (e.g. employment). The authors of this book who are also the main strategists of the ECB, have done something remarkable in reinterpreting the Treaty. In their view, which has become the official ECB view, the central bank makes the best possible contribution towards achieving the other objectives mandated by the Treaty just by maintaining price stability. Just focus on price stability and all the rest will follow automatically. Therefore, to take up our question again: How does one measure the success of a central banker? The answer given by Issing and associates is simple. Just check the inflation numbers.

It is clear that there is something missing here. Anyone who cares to look at what happened in Japan will see that success in maintaining price stability does not yet guarantee that the central banker of this country will be put in the list of the ten best central bankers in the world.

The view defended by Otmar Issing and his associates is perfectly understandable. It has also become the mainstream view among academic economists. Coming after decades of over-ambitious monetary policies leading to monetary instability in most countries and hyperinflation in many others, caution and limited ambition are virtues

for a central banker. If there is one message from Issing's book it is this: We know very little about how monetary policies affect output and employment, except that their effects are temporary. The scope for making major policy mistakes trying to stabilize output is great, and can easily lead to galloping inflation, as it did in the past. Conversely, we know that increases in the money stock ultimately lead to price increases without permanent effects on output. Isn't this sufficient to preach caution in the use of monetary policies for other objectives than price stability?

The issue will continue to be debated by academic economists. And surely, there are strong arguments in favour of cautionary orthodoxy. Too much misery has been inflicted by excessive ambitions of monetary authorities. And yet this orthodox view leaves a taste of dissatisfaction. Doesn't Greenspan's Fed show that it is possible to do better than just being the guardian of price stability? Bob Woodward and many observers of the Fed will answer positively. Others will say that the final verdict on the success of Greenspan's Fed has yet to be made.

The interesting thing in this debate is that the ECB policymakers themselves have shown doubts about their own position in the debate. Despite the strong rhetoric about price stability, the ECB has shown considerable pragmatism in its actions. In the last chapter of their book the ECB strategists describe the monetary policies of the ECB during the first year of its operations. In April 1999, the ECB decided to lower the interest rate. Inflation was around 2%. If inflation had been the only objective of the central bank, there would have been no reason to lower the interest rate. The fact is that the ECB cares about more than just price stability. Its rhetoric may say that only price stability matters, its actions show that it pursues a wider range of objectives than just price stability. So, there is good and bad news. The good news is that the ECB is not the dogmatic institution that some (especially French politicians) think it is. The bad news is that the ECB's credibility is hurt by the gap between its words and its deeds. But maybe this is the inevitable fate of a new central banker. Once its reputation of toughness about inflation will be well established, it will be able to use its considerable power to stabilize output without creating fears in the market that it is reneging on its first objective. The secret of the Fed's success seems to be precisely that: its hard won reputation of inflation fighter allows it to stimulate the economy in a recession without creating expectations of inflation. Market participants know that the Fed will return to monetary tightness if price stability is at risk.

Success and failure of central banks have to do not only with the objectives they pursue, but also with the way they try to achieve these objectives. Again the contrast between the Fed and the ECB is great. These differences manifest themselves in many ways. First, there is the decision making process. The ECB rules by committee, the Fed is pulled forward by the Maestro. All this makes for a much more exciting reading of Woodward's book than of Issing's. The story of the Fed is the story of a man who guides the decisions of the central bank his way. Opposition is futile, as some members of the Board found out. There is, of course, a danger of exaggerating the influence of one man in the policy decision-making process of the Fed, and Woodward does exaggerate and personalize the story of the Fed too much. But there is no doubt that the contrast with the ECB is great. The ECB is evolving into a committee-ruled institution in which the President is only one person among equals.

All this leads to the issue of what is best: A committee or a leader (charismatic or not)? The closer central banking comes to being an art, the better the leadership system seems to be (provided we are capable of selecting the right leader). After all, few works of art have ever been created by a committee. The closer central banking moves towards becoming a science the better are the prospects of decision-making by committees. Committees are better suited to collect and to process the information needed to come to the right decisions. So, let's be optimistic. Central banking will increasingly become a science. This means that the right decision making mode is the committee. The ECB may be showing the way the Fed will have to take in the future.

What about transparency? Here we reach one of the greatest paradoxes in our comparison of the Fed and the ECB. There is now a large consensus among economists that transparency is of utmost importance for success in central banking. Central bankers should state their objectives clearly and precisely; they should announce how they want to achieve this and leave nothing hidden. All this will minimize uncertainty and will ensure predictability in policy making. And we all know markets love this.

How do the Fed and the ECB score on this point? There can be little doubt. The ECB is the more transparent central banker of the two. It is quite clear about its inflation target. In contrast, to this day the Fed has not come up with any number giving precise content to its inflation objective. Both Greenspan and Duisenberg appear before their respective parliaments, but the impression one gets is that Greenspan's

pronouncements are little more than Delphic oracles full of ambivalence and imprecision. Finally, and most importantly, the Fed's authorities still have to publish a book similar to the book of Issing and his ECB associates in which the objectives and the strategies are spelled out in great detail.

So, why then has the Fed been able to get away with ambivalence while everybody today claims that transparency is necessary for success. And why has the greater transparency of the ECB not contributed more towards the ECB's perceived success? Difficult questions, to which I have no clear answers. Surely, the problem of the ECB is that it has spelled out its strategy in great detail. In some crucial areas, however, it has not practised what it announced. As argued earlier, there is a discrepancy between its anti-inflationary objective and its pragmatism. The ECB has set its inflation target rather low, creating the risk that inflation will be observed outside the target range of 0 to 2% quite often. In fact during more than half of the time since the ECB came into existence this has been the case. This discrepancy between the announced inflation target range and its realisation hampers the establishment of firm credibility. We will add another such discrepancy when we discuss the ECB's two-pillar strategy.

Some have argued that the Fed's lack of transparency can be turned into an advantage. The more outspoken and precise a central banker is about its present and future policy actions, the greater the risk it takes that at some point, because of unforeseen circumstances, it will have to do something different from what it announced. And here the superiority of the Fed's approach may reside: ambiguity in a very uncertain world gives the Fed more flexibility to react to unforeseen events without being perceived to be a liar. This idea was labelled "creative ambiguity" by Cukierman and Meltzer(1986) in a well-known paper.

The last area of contrast between the Fed and the ECB about the way these institutions conduct their business has to do with money targeting. As explained in great detail in Issing et alii's book, the starting point of the monetary policy strategy of the ECB is the Friedmanian insight that inflation is always and everywhere a monetary phenomenon. In the first two chapters of the book, the ECB top strategists provide us with an impressive survey of the nexus between money, prices and output. Two neutrality propositions seem to be firmly established by a wide range of theoretical and empirical studies. The first one is that in the long run money and prices move in the same proportion; the second one is that in the same long run

money has no influence on output. These results are then used to justify the two-pillar approach of the ECB, which gives prominence to money growth (M3) in guiding monetary policies. With this emphasis on money growth as the most important variable guiding monetary policies, the ECB is the only major central bank using such an approach to target the rate of inflation.

The problem with much of the empirical research about the long run relation between money growth and inflation is that it includes a lot of observations on *periods* of relatively high inflation (in time series analysis) or on *countries* with high rates of inflation. This problem is well illustrated in the following cross-section evidence. It shows a very tight relation between the 30-year average of inflation and money growth in a sample of more than one hundred countries. Subjecting this kind of evidence to regression analysis invariably finds that the hypothesis of strict proportionality between inflation and money growth cannot be rejected and that most, if not all, of the differentials in inflation between countries can be explained by differentials in money growth. This kind of cross-section evidence has now invaded textbooks to show that the evidence in favour of the quantity theory is overwhelming. (See for example, Parkin, Powell and Matthews(2000).

When one looks at a subsample of countries with low inflation, things get fuzzier. We show this in figure 2 where we present a subsample of countries, which have experienced an average rate of inflation of 5% or less during 1970-1999. We observe now that there is very little relation between inflation and money growth in these 'low'¹ inflation countries. Put differently, differences in money growth between countries are uninformative about the differences in their rates of inflation. The remarkable thing is that these are not short-term but long-term sustained differences. This lack of relation between long run money growth and inflation among low-inflation countries is not altered when one corrects for differences in the growth of output². It appears therefore that when inflation is low, sustained differences in inflation experiences of countries cannot easily be traced to sustained differences in money growth.

¹ Many central bankers today would not call a yearly rate of inflation of 4 or 5% maintained during thirty years a low rate of inflation. If we restrict our subsample of low inflation countries to those countries with inflation less than 3% a year, the absence of a link between inflation and money growth is even more striking.

² See De Grauwe and Grimaldi(2001)

Figure 1

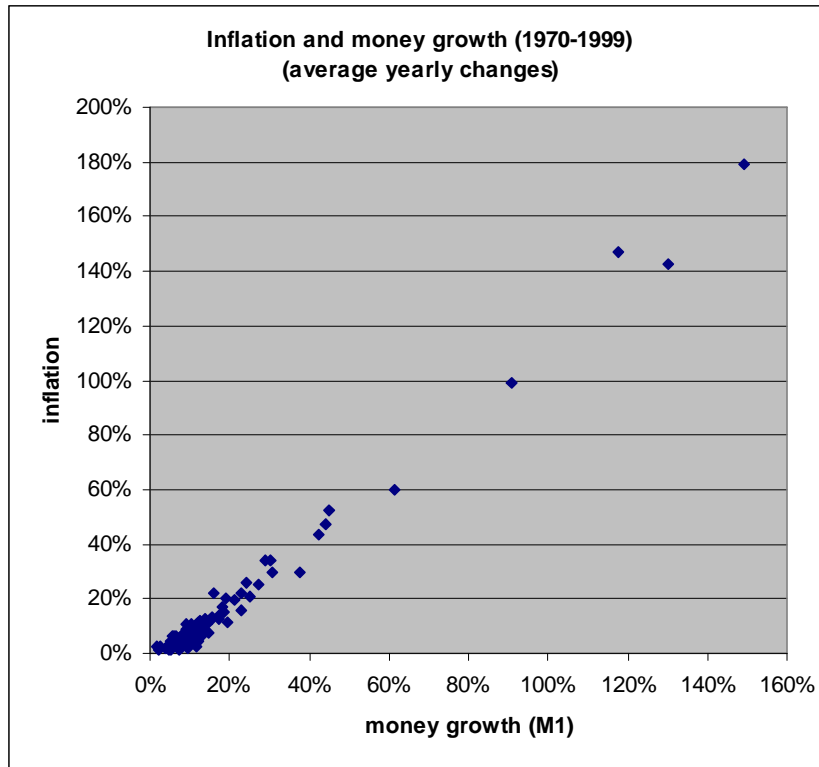
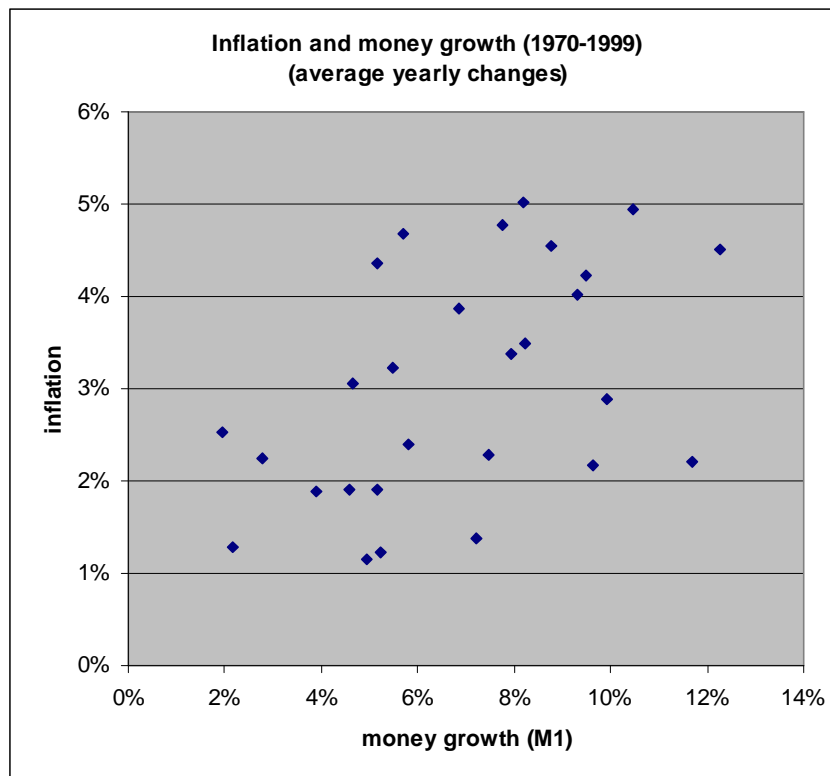


Figure 2



Source: IMF, International Financial Statistics, CD-Rom, Aug. 2001

It is not difficult to understand this result. Money supply statistics are full of noise. In a low inflation environment where inflation is only a few percent a year, the observed differences in the money supply growth numbers contain mostly noise, and say little about differences in monetary policies (the signal).

All this confirms what many critics have been saying about the first pillar of the ECB monetary policy strategy, i.e. that the prominence given to money in guiding monetary policies is mistaken. Given that it is the ambition of the ECB to keep the rate of inflation below 2%, success on the inflation front will make the yearly money growth numbers even less informative about the inflationary potential in the economy than appears from figure 2, because the noise to signal ratio will be even higher.

The ECB's insistence on giving such prominence to money growth figures will put it in an uncomfortable situation in which it will have to explain all too often why it does not want to take the latest money growth numbers seriously. It will have to argue too frequently that because of some new statistical quirk the money growth numbers are uninformative about the inflationary potential in the eurozone, and should therefore be disregarded. All this does not help the ECB to establish its credibility quickly.

The Fed has learned this lesson. Since the second half of the 1980s it has systematically downgraded the importance of money growth numbers. Today, these numbers play almost no role in setting monetary policies. This has saved Greenspan the trouble of having to explain with a great degree of frequency why the money growth targets were not met.

The danger in writing a story about success and failure of central banks is that one does not really know when the judgement should be made. The book of Woodward was written in the year 2000 when the new economy performances of the US economy were taking fairy tale dimensions. Against this background the success of the Fed and of its Magician seemed obvious to everyone, except to spiteful cynics. Two years later, in 2002, the success seems less obvious. There is increasing evidence that the stock market boom (some non-Chicago economists will call it a bubble) was at least in part fuelled by the large infusion of liquidity by the Fed after the Asian crisis of 1997. Therefore the subsequent bust also had something to do with the Fed's policies.

The final judgment on the successes of Greenspan has still to come. If the US manages to get out of the recession of 2000-2001 quickly, then there will be no doubt that Greenspan was a Great Magician. If, however, the recovery is more protracted because firms and consumers find it difficult to extricate themselves from the debt build-up of the second half of the 1990s, then Greenspan will lose much of his aura. He will then be seen as being responsible (at least in part) for an unsustainable debt accumulation that his policies helped to create. Bob Woodward's saga of the Maestro will have to be rewritten.

The president of the ECB who is retiring soon will have to worry less about his place in history. Despite the criticism that one may formulate about the ECB (and I have not hesitated to do so in this review) the striking fact is that the ECB can show a favourable record. Inflation has remained low; economic growth during the first three years was above average. The ECB did nothing really spectacular, no great feats, no big policy mistakes. A big contrast with the Fed.

But could it be that success of central bankers should be measured not by the excitement it generates but by its ability of creating boredom with the population? Is it the case that when central banks can excite nobody, we have evidence of success and that when they create excitement we are close to disaster? If the answer is positive, the ECB could turn out to be more successful than the Fed.

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