No Fixed Policy Rules for the Monetary Policy of the ECB: An Interview with Otmar Issing
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Monetary policy has something to do with money, and in the long run the sentence by Milton Friedman applies which says that inflation is a monetary phenomenon. "Given this background, I cannot support monetary policy that cuts out the monetary base." Otmar Issing, chief economist of the European Central Bank (ECB) said this is an interview with our newspaper. Issing defends the monetary policy concept of the ECB as one that is best suited for the circumstances of the monetary union. Being tied to a fixed policy rule is out of the question for the ECB – not in the form of a fixed monetary base rule nor as a direct inflation goal.

After the interest rate hike at the beginning of this month, the quality of the critique of the ECB has surprised Issing more than the amount of critique. "When preparing an interest rate decision, it is usually possible to imagine what the comments are going to be just by looking at previous experiences." Issing had anticipated the critique that the ECB only increased rates because the Fed had raised interest rates the day before. Before making a decision, there are always tactical considerations. "I think, however, that we cannot consider whether our decision will be interpreted in this or that way. If we are convinced that we need to do something, then we do it at a time that we think is right," say Issing. "Imagine we had waited for another 14 days. Then people would have said that the ECB only waited so long to not look like they were following the Fed's decision." A young central bank has to convince the public of its independence.

Issing also refuses to accept the interpretation that the weak Euro was responsible for the rate hike. "During the last year, we only increased interest rates once, but left it unchanged otherwise – during a period in which the Euro was falling. In doing so, we demonstrated that the importance of the exchange rate depends on our general monetary policy goals." The Euro is an important part of the so-called "second pillar" of a strategy that looks at a multitude of indicators to determine the risks of an increase in prices. "The importance of the exchange rate during the past 12 months has of course changed: The Euro is clearly weaker than at the beginning, and the entire situation has changed as well." Exports are only 17 percent of the gross domestic product in Euroland, and this percentage is a lot smaller than it was for each country at the beginning of the monetary union. "We never claimed that there won't be any influences from international linkages." Prices on world markets are rising. Import prices reflect this trend. "But we did not scream 'Alarm!': There is inflationary pressure from world prices and this is what is causing us to act. The exchange rate was only one element in our analysis." The first pillar of the monetary policy concept of the ECB is the monetary base. Given the goal for the monetary base, there was an excess of money in circulation, and there was a lot of liquidity in Euroland. The exchange rate is always at the center of the public debate, but it is only one of the many factors that determined the rate hike, reiterates Issing. "Whether we communicated this connection well is another issue, and we can talk about that."

Issing contradicts the thesis that as long as the monetary base is under control, rising import prices and wage contracts do not matter for inflation. "If you are convinced that there is a stable relationship between money and prices, then you can introduce a monetary goal and follow that very closely." The evolution of the monetary base can only be a general and medium-term orientation for the evolution of prices. "The ECB takes these linkages – as opposed to all central banks – seriously. This is the reason we do have a first pillar, the monetary base." It is not understandable according to Issing why the development of the monetary base should not have provided reason enough for monetary policy action. The provision of liquidity in Euroland alone was reason enough for the interest rate hike.

I understand the desire for monetary policy rules, that is often expressed, says Issing. He is also a supporter of a policy that is tied to a rule.

“The question is only, where does a reliable rule come from?” Some analysts, market observers and academics would recommend the use of a Taylor rule, that is due to an idea of the American economist John B. Taylor. According to this rule, the central bank should set interest rates in dependence of an inflation gap, given by the difference of actual and desired inflation, and an output gap, given by the deviation of actual economic growth from potential. In the early ‘90s, Taylor tried to explain Fed policy ex post. In the meantime, the rule has become a normative theory. “The Taylor rule is quite important for us, because it gives us guidelines for the stance of monetary policy. But the rule cannot be a directive for our policy,” say Issing. At the moment, nobody knows the equilibrium real rate for Euroland, and this rate plays a central role for the Taylor rule. In addition, it is not advisable for a central bank to make economic growth one of its objectives. “We take such discussions seriously, and we talk with leading experts from all over the world about this,” says Issing.