Bundesbank and ECB – Monetarist strategies?

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1. The Bundesbank's monetary target

In 1975, the Bundesbank announced a money supply target for the first time. With a number of technical modifications, it stuck to this strategy until the D-Mark was replaced by the Euro on January 1, 1999. From the outset, the Bundesbank declared that it would not align its monetary policy strictly with the annual money supply target and described its strategy as "pragmatic monetarism" (Issing et al. 2005). This immediately brought criticism from "true" monetarists such as Karl Brunner and Manfred J.M. Neumann, who, in short, denied that the Bundesbank's monetary policy strategy and practice even deserved the name monetarist.

Despite this criticism, the Bundesbank was widely regarded as a representative of monetarism, at least in terms of its categorization. A number of authors from the Anglo-Saxon world "accused" the Bundesbank of actually pursuing a policy of inflation control under the guise of the money supply target.

2. The ECB's monetary policy strategy.

When I was appointed to the Executive Board of the ECB, I was given responsibility for the Directorates General Economics and Research.

The first President of the ECB, Wim Duisenberg, gave me complete freedom and assured me of his unconditional support.

The most important task and at the same time the greatest challenge was to develop the monetary policy strategy of the new central bank for a new currency, the euro. There was not much time. In seven months, a new era would begin with the introduction of the euro. At first, the matter seemed quite simple. Over the last two years, I had argued in several articles that the ECB should decide on a money supply target. The decisive argument was that this choice would transfer the credibility of the Bundesbank, which was recognized throughout the world as an anchor of price stabitity, to the new institution, the ECB.

Having moved from the position of chief economist at the Bundesbank to the same position at the ECB, what was for me so far a theoretical question became a problem of concrete monetary policy and the corresponding responsibility.

First of all, I abandoned the idea of a money supply target. The Bundesbank had missed its monetary target roughly half the time. This was also the case during my term in office. This forced me to explain to the public the reasons and justifications for why we were sticking to the money supply strategy and were convinced that we would reach the target again in the foreseeable future - which is what happened. The probability that the development of the money supply after the currency changeover to the euro could be extremely volatile, possibly even erratic, should not be underestimated. How could it then succeed, as in the case of the D-Mark, in convincingly explaining the deviation combined with the assurance that the development of the money supply would swing back to the level of the agreed target? There was a great danger that the ECB would have to admit that its strategy had failed shortly after assuming monetary policy responsibility. That would have been a catastrophe for a new central bank that was already surrounded by mistrust. For me, this ruled out a money supply strategy for the ECB.

In the next step, I formed a group of excellent economists from the fields of economics and research to discuss the problem of the ECB's future monetary policy strategy. To the surprise of my colleagues, who were familiar with my previous publications, I opened the first meeting by stating: There will be no ECB money supply target, not even in the pragmatic Bundesbank variant. But "money", understood from the outset in the broadest sense as a term for monetary factors, should play a prominent role. Let us develop a strategy that meets these conditions.

It was also necessary to take into account the extreme degree of uncertainty associated with the introduction of a new currency. The euro area was only created when the decision was made about the 11 participating states on May,2 1998. It would therefore take a considerable time, well after the launch of the euro, before reliable data would be available. Accordingly, it was also necessary to develop completely new models and projections for the new currency area.

As a result of our discussion I proposed a monetary policy strategy to the Board and Governing Council , which was adopted by the Council on 13 October 1998 and announced publicly on the same day (Issing 2008). The soon-to-be-named " Two Pillar Strategy" is based on the following two elements.

1) The monetary analysis, which initially included a reference value for the growth of the M3 aggregate and was expanded over time into a comprehensive analysis of the monetary and financial sectors.

2) The economic analysis. The economic pillar was based on an assessment of a wide range of indicators from the real sector relevant for the outlook of price stability in the euro area .

   The essence of the two-pillar approach is that the information produced under one methodological perspective is always cross -checked against information and analysis produced by the other. It provides an effective insurance against the uncertainties and complexities of the economic environment , guaranteeing the robustness of monetary policy decisions and reducing the risks of policy errors . The effort to analyze and reconcile results from different perspectives stimulates deeper analysis and ultimately leads to a better understanding of the economic situation.

   A key element of this strategy is the medium- term orientation which means that the conduct of monetary policy is focused at maintaining price stability over the medium term.Two aspects are relevant. From an ex-post, accountability point of view, it acknowledges the existence of short-term volatility in prices, resulting from shocks which cannot be fully anticipated. Quite obviously monetary policy cannot be held responsible for short-run deviations from price stability that it cannot control. From an ex- ante, forward-looking point of view, the medium- term orientation reflects the lags and uncertainties facing the central bank, recognizing that monetary policy would be ill-suited to actively fine tune short-term economic developments. Furthermore, a medium- term perspective is important in order to permit a gradualist and measured response to some kind of economic disturbances – such as supply shocks – thereby avoiding introducing unnecessary volatility into the real

economy. In this way, it embodies a concern over, and contributes to, the stabilization of output in the economy .
It is obvious that these elements were of particular importance in the case of a new currency [1].

3. ECB – A monetarist strategy?

Although the two-pillar strategy was even further removed from the ideas of Milton Friedman or Karl Brunner than the pragmatic approach of the Bundesbank, the ECB was widely seen as a kind of last bastion of monetarism. This assessment also applied to those national central bank presidents who had more or less since long stopped paying attention to money supply developments in their central banks. Incidentally, another group of central bank presidents was disappointed that I had not proposed a money supply strategy. It was precisely because of this fundamental difference of opinion that the separation into monetary and economic analysis proved to be an almost perfect framework for a structured discussion, which ultimately led to a common denominator for monetary policy decisions through cross-checking .

In the media and not least in the Anglo-Saxon dominated mainstream, the ECB was seen as the last representative of a hopelessly discredited monetarism. As this conference is under the motto 50 years of the Shadow Open Market Committee, I would like to briefly address the discussion with the ECB watchers. From the very beginning, in the tradition of the Bundesbank critics, they were

[1]The process of this discussion and decision-making is documented in detail in a book that was published soon after the launch. The book also discusses the definition of price stability in detail (Issing et al. 2001).
A crucial element of the strategy was also the statement that the ECB interprets price stability as an annual average increase in the Harmonized Index of Consumer Prices of below 2%. At the first review of the strategy in 2003, the ECB stated that it would pursue a course of keeping the increase "close to, but below, 2%". The definition of "below 2%" was mainly due to the special situation of price developments before the launch of the euro. At the next review in 2020, the ECB announced a symmetric inflation target of 2%.

negative about the ECB's strategy and above all about the importance of monetary analysis. The first verdict was extremely negative. In a report under the title "The ECB: Safe at Any Speed?” (Begg et al. 1998) the verdict – before the launch of the Euro!- was clear and scathing : “ At present, it is both weak and unprepared ” – as if we at the bank had decided on the early begin of monetary union.

The comment from the 2004 report (Gali et al. 2004) is telling: “In its policy choices the ECB has not given much attention to monetary growth rates so far. Rather, this has been a rhetorical means to borrow the reputation of the Bundesbank as the guarantor of a stable European monetary policy . With the ECB now able to walk by itself , it no longer needs the Bundesbank monetary crutch.We have carefully examined in this chapter whether there can be some special role for monitoring the growth rate of a monetary aggregate – assuming that the ECB surely should and does monitor medium- term inflationary trends – and we did not find any . We therefore view the new strategy as slowly adjusting the original monetary pillar towards a clarification of what the ECB really means by its still opaque 'medium- term' orientation of its inflation policy goals ” (p.33).

By and large, this is the tone in which the ECB’s strategy has been criticized by the majority of macroeconomists, not to mention the media.

4. Monetary policy without money?

For me, as the “inventor” of the two-pillar strategy , it was a constant challenge to explain this approach and defend it against sometimes fierce criticism.[2] This also came from other central banks and was primarily about the importance that the ECB gave to monetary analysis. I discussed the reasons for our decision in detail with these colleagues and did not ignore problems. I regularly ended such discussions with the comment: Let's leave the criticism of the ECB strategy aside for now. How does your central bank deal with the problem - by simply ignoring developments of money and credit? As a result monetary policy without any consideration of monetary factors?[3]

Monetarism seemed to be discredited by the collapse of the quantity-theoretical relationship between money supply and prices. This is what numerous authors have pointed out for developments in the 2010s.[4] This is certainly a warning for the central bank not to opt for a strict money supply strategy. But, is this an argument to exclude money from the analysis of inflation as this is the practice now im most central banks? The neglect of monetary developments evidently went so far that even high growth rates of the various monetary aggregates were seen as unproblematic. "..I do think it would have been sensitive to ask in 2020 and 2021: if broad money is growing at 25%...a year , what is going on here ? In the past decade , central banks have unfortunately abandoned reporting on and monitoring the broad monetary aggregates ” (King 2024).[5]

At its core, the decisive factor here is the assessment of inflation targeting . As this strategy defined and referred to as “state of the art ” is now being practiced by all major central banks after the ECB

[2]Incidentally, the term “ two pillar ” was not mine at all. It was created spontaneously during a press conference of the President

[3]For example, I have heard numerous speeches by Greenspan on the Fed 's monetary (!) policy in which not only did the term money not appear, but no nominal quantities were mentioned at all.

[4]To use Friedman’s words, at that time money was not “chasing” goods but assets. Was it not reckless to ignore the danger posed by this?

[5]One could think of the man who considers himself fit to drive after a glass of beer and then believes that this also applies when completely drunk. By the way the ECB still reports on the development of money and credit.

joined this camp, it is an approach of “monetary policy without money”. But this weakness goes even further. “ No model of inflation targeting exists so far which integrates the risks from the banking system and financial markets with all their dynamics , non- linearities and overall complexity . Central banks should agree that the search for an “optimal” monetary policy regime has not come to an end and inflation targeting might entail risks and shortcomings . From this perspective , one could argue that a situation in which central banks follow the same strategy might also bring systemic risks and that there are benefits to a more diversified and robust approach ” (Issing 2020).

These weaknesses of the theory of inflation targeting have been shown again in the recent phase of high inflation. Based on the reactions of the relevant representatives so far, one must expect that they see the "solution" in refining the models, resulting in increasing complexity (see King 2024). Based on previous experience, it is difficult to imagine that this path will lead to success.

5.Is monetarism dead?

The Bundesbank's "pragmatic" money supply strategy was accused by leading monetarists of not being a "monetarist" approach, while the majority of criticism from the other side placed the Bundesbank in this camp. As shown, the discrepancy is even more striking when assessing the ECB's strategy.

In short, it seems as if any approach in which the development of the money supply plays a role is classified as "monetarist" and thus relegated to the dustbin of disproven ideas. This is especially true of the quantity theory. But shouldn't centuries of experience advise a more cautious assessment? Shouldn't research for example also devote more attention to the question of how to define the money supply relevant for the relationship to inflation in times of rapid growth in electronic means of payment ?

Whatever one may call "monetarism" today, one cannot simply ignore the importance of the development of the money supply for inflation. Mervyn King once summed it up succinctly: " No money - no inflation".

Over 100 years ago, Joseph Schumpeter (1918, p. 116) warned: “And all the defects of metallism and the quantity theory, which I have certainly not defended…, do not change the fact that in the theories so often condemned under these titles there is a great deal of sound insight, a great deal of practical wisdom – which even today is a more reliable guide than much of what the writings of the day offer. Above all, there is seriousness and sincerity in them, which we urgently need” (translation OI).

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