The Bundesbank: a view from the Bank of England

Mervyn King, Executive Director and the Bank's Chief Economist, describes [1] the historical links, the similarities and some of the differences between the Bundesbank and the Bank of England.

He concludes that the principal aim of any central bank is to eliminate macroeconomic instability which, though not always straightforward, is a necessary condition for economic success. Mr King argues that it is this shared commitment to stability which provides the real basis for European monetary co-operation. The differences of form, structure and organisation are secondary to the fundamental intellectual conviction that good governance of the economy goes hand in hand with price stability.

Historical links

Those whose memory stretches back no further than 16 September 1992 might be under the false impression that links between the Bundesbank and the Bank of England were damaged by those events. In fact, the relationship between the two institutions is close. And even the sharp contrast between the perceptions of 16 September as either Black Wednesday or White Wednesday will in time fade and come to adopt the hues of a painting in the grisaille style.

The Bundesbank and the Bank of England share a common approach to monetary policy and there are important similarities in our monetary history. The development of central banking in Germany predates the creation of the modern German state. The Royal Bank of Berlin, founded by Frederick the Great in the eighteenth century, was given the management of Exchequer funds. In 1846 it was reconstituted as the Prussian Bank and its notes made legal tender. The decree establishing the bank stated specifically that its task was 'to prevent any great rise in the rate of interest, and it was, in fact, forbidden to raise the rate for lombard business above 6 percent' (Smith 1936, page 53). No doubt the critics of the Bundesbank wish that the clock could be turned back 150 years! In turn the Reichsbank evolved out of the Prussian Bank, and the Act which created it in 1875 was heavily influenced by the 1844 Bank Charter Act.

It is interesting to reflect that the central banks we see today in both Britain and Germany emerged out of privately-owned commercial banks. They represented a market demand for such an institution (see Goodhart, 1988). In times of financial difficulty the need for co-ordination—and the difficulty of achieving this by co-operation among competitive commercial banks—led to the emergence of a single dominant bank that could play a co-ordinating role. But the conflict of interest between this quasi-regulatory role and the objectives of a privately-owned profit-maximizing bank led to the development of non-competitive institutions charged with the responsibility of managing the financial system in times of stress and preventing excessive note issue. The lender of last resort must be above the competitive battle.

The primacy of price stability as the principal objective of a central bank is a more recent development. It stems from two factors—one success and one failure. The success is that the practice of the lender of last resort function has greatly diminished the probability of systemic collapse of the financial system and contagion between institutions and markets. Operating behind the scenes central banks have reduced the number of financial crises. This means that monetary policy can be devoted to the goal of price stability. The failure is that the expansion of fiat currencies has provided governments with a temptation that has often proved too great to resist. And the resulting inflation has eroded the value of money by more in this century than in the previous millennium. Indeed it was the experience of not just one, but two hyperinflations which made it possible for the Bundesbank to acquire the powers and the mandate to achieve price stability. And, in a less dramatic way, the experience of inflation over the past quarter of a century in this country, which has eroded the value of money by almost 90% during that period, has produced a commitment by all major political parties to the importance of monetary policies designed to maintain price stability.

Since the Bundesbank was set up in 1957 Germany has had the lowest inflation rate of any major economy. Between 1957 and the end of last year the average inflation rate in Germany was the lowest of any OECD country. The table below shows the average inflation rate of the G7 countries between 1957 and 1992, as measured by consumer price

Inflation in the G7

Average consumer price inflation 1957–92, per cent per annum

United States	4.7
Canada	5.0
Japan	4.9
Germany	3.4
France	6.8
Italy	8.5
United Kingdom	7.2

(1) In a speech to the German Chamber of Commerce and Industry in London on 25 March.

indices. Sad to say, the United Kingdom had the second worst record, with an average inflation rate of over 7% in that thirty-five year period. But the Bundesbank has been able to hold inflation below $3^{1}/_{2}$% over its lifetime. Although the past thirty years have not been vintage ones for inflation performance among the G7, Germany is clearly top of this premier league. The Bank of England, of course, goes back not thirty but three hundred years. And in defence of our record I would note that, although prices in the United Kingdom have increased seventy-fold since our inception, that is less than the increase in prices in a single month in Germany in 1923.

The past record matters in so far as it affects expectations of inflation in the future and the credibility of statements of counterinflationary intent by central banks. A good measure of this credibility—in a world of unrestricted capital mobility in which the real rate of interest will be similar across countries—is the long-term nominal interest rate. Despite the attention paid to the high level of short-term German interest rates since unification, we should not forget that long-term rates have, for a considerable period, been lower in Germany than in other EC countries. At present long-term rates in Germany (as measured by the redemption yield on ten-year bunds) are 6.6%, compared with 7.4% in France, 7.8% in Britain, and no less than 12.8% in Italy. This difference in long-term rates is a measure of the additional credibility that attaches to monetary policy in Germany. Long-term rates are lower than short rates in Germany. In Britain long rates are higher than short rates. In fact the comparison between short and long rates reveals something rather interesting about the market expectation of future short rates. Using the yield curve for interest rates, it is possible to work out the implied interest rate that is available today for any short period in the future. This is likely to be a good estimate of the current expectation of the short rates that will prevail in these future periods. Chart 1 shows the short-term interest rates expected to prevail in the future which are implied by the currently observed yield curve (as of 23 March). As you can see short-term interest rates are expected to be higher in the medium term than at present, and in the long run are expected to settle down to a level of around 9%. As we wrote in the Bank's first *Inflation Report*, 'expectations of inflation have not yet adjusted to levels compatible with a target range for inflation of 1%–4%'.

Chart 1
Implied forward interest rates

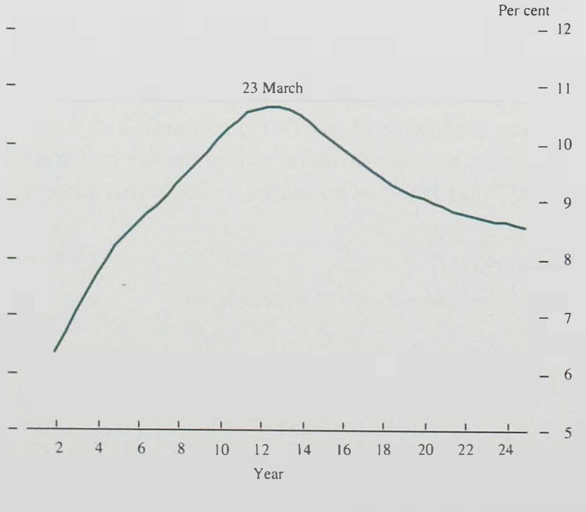


Chart 2
Implied forward interest rates

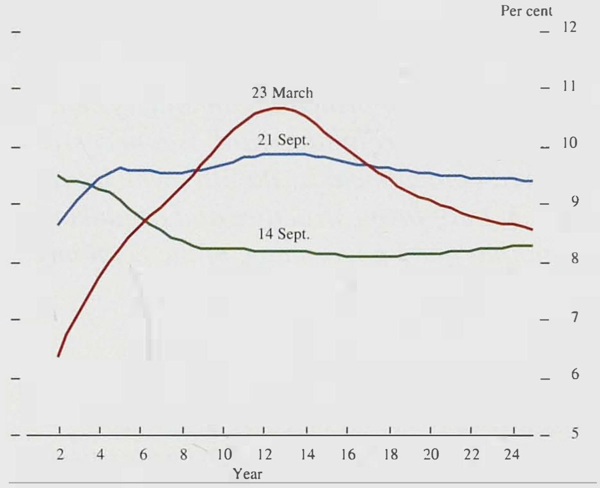
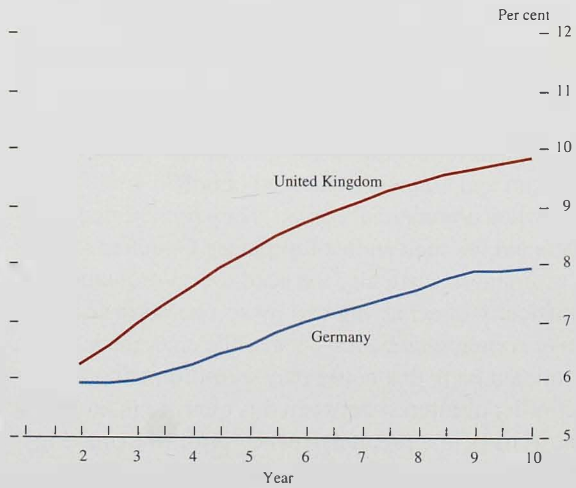


Chart 2 shows how these expectations have changed since our forced departure from the ERM in September. Departure from the ERM led to sharply lower expected interest rates in the short run. By contrast, rates in the long run were expected to be higher than before, suggesting that there was some loss of counterinflationary credibility from our exit. But this loss was small and since then there appears to have been some restoration of long-run credibility. And there is no reason to suppose that the new policy framework—an explicit inflation target—will be unable to deliver a credible basis for monetary policy, provided that the inflation target is achieved in the first few years.

Chart 3 shows the pattern of expected interest rates in both the United Kingdom and Germany over the next ten years.

Chart 3
Implied forward interest rates



United Kingdom rates derived from par yield curve
German rates derived from Bund par yield curve

It is this chart which shows how much we have to catch up in order to acquire the degree of credibility which attaches to the Bundesbank. A successful track record of low inflation over several years will do more than anything else to diminish this gap. In the last resort credibility comes from actions. The Bundesbank has earned its reputation, not by flaunting its independent status, but by its willingness to take the difficult decisions that are necessary to combat inflation.

Is it possible that the apparently greater credibility of counterinflationary policy in Germany can be explained in terms of a comparison between the Bundesbank and the Bank of England? Since so much popular discussion of this question focuses on the differences between the two institutions, let me start by analysing the similarities before turning to the differences.

Similarities

There are two important similarities in our approach to monetary policy. The first is a common institutional commitment to price stability as the primary goal of monetary policy. It is the first of the Bank of England's core purposes, and we share an intellectual conviction that in the long-run economic growth is determined by real factors. The similarity can best be illustrated by considering the respective remits of the Bundesbank and the Bank of England. One is the 'aim of safeguarding the currency' but 'without prejudice to the performance of its functions [it] shall be required to support the general economic policies of the Government'. The other is that the 'central responsibility should be to support the government in its determination to bring about a lasting reduction in the rate of inflation'. Which one is the Bundesbank? Actually, the remit which contains an explicit mention of inflation is the terms of reference given to Eddie George on his appointment as Governor of the Bank of England from 1 July. So there can be little doubt that the objectives of monetary policy are common to us both.

The second similarity is a shared commitment to the view that sound public finance is crucial to the control of inflation. Large fiscal deficits—if sustained—raise the risk that governments will allow monetary growth to increase and use inflation to lower the real burden of public debt. That is why it was important for the Chancellor last week to take action to reduce prospective fiscal deficits. As Keynes put it in 1923, when discussing inflation in Germany as a way of financing government:

> 'It is common to speak as though, when a government pays its way by inflation, the people of the country avoid taxation. We have seen that this is not so. What is raised by printing notes is just as much taken from the public as is a beer duty or an income tax. What a government spends the public pay for. There is no such thing as an uncovered deficit. But in some countries it seems possible to please and content the public, for a time at least, by giving them, in return for the taxes they pay, finely engraved acknowledgements on watermarked paper. The income tax receipts . . . we in England . . . throw into the wastepaper basket; in Germany they call them bank notes and put them into their pocket-books' (Keynes, 1923 pages 52–3).

Differences

The two similarities that I have identified are matched by two important differences between the Bundesbank and the Bank of England.

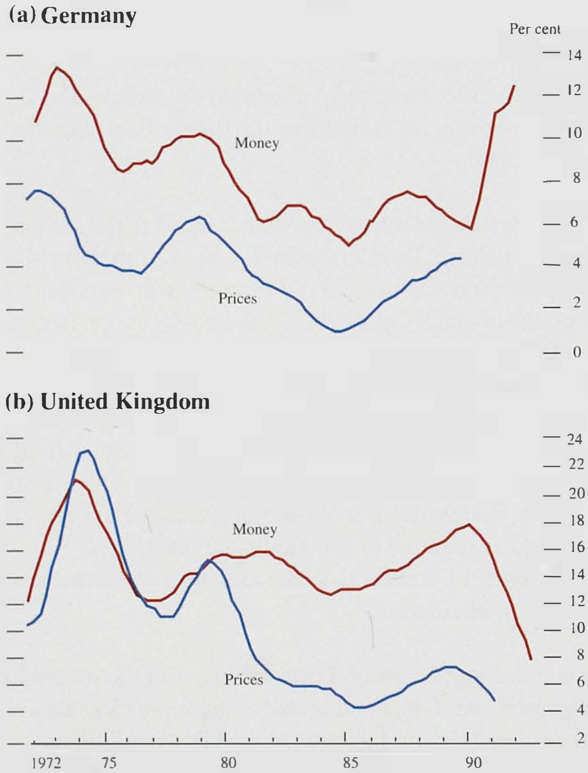
The first concerns the role of monetary targets in the setting of monetary policy. The Bundesbank's view of the role of money in the economy was set out recently in an excellent article by Professor Issing (1992). Like most economists, the Bundesbank subscribes to the view that in the long run money is neutral with respect to output. Unanticipated changes in monetary policy may have short-run effects on output. But, in the long run, output will return to its natural growth path—a path determined by real factors. The role of the monetary authorities is to ensure that monetary growth is only as rapid as required to accommodate the desired long-run growth of nominal income and the trend growth in the velocity of circulation.

This much is common ground between us. But the means by which we proceed to that end is one of the more obvious differences between our institutions, and is something on which I should like to dwell for a few moments, if only to note that the difference may be more apparent than real. Although economic theory has a good deal to say about the role that money plays in the economy, it remains uncomfortably vague about the appropriate definition of money—especially in economies in which methods of payment have changed radically over time. The practical difficulty of identifying the most appropriate measure of money has meant that, over the years, the attitude of policy-makers towards monetary targeting—as a means of monetary control—has been largely dependent on the behaviour of particular definitions of money, and in particular the stability and predictability of their velocity of circulation.

In 1974, the Bundesbank was the first central bank to introduce monetary targeting. It has continued with targetry ever since, although the targeted aggregate has changed (from CBM to M3), as has the form in which the target has been specified. And, notwithstanding the fact that inflation in Germany has been higher in the years since the adoption of monetary targets than it was before, the success of their approach is evident.

The Bundesbank's approach is usually contrasted—often in a pejorative fashion by our critics—with the UK experience, in which the emphasis on monetary targets was significantly reduced during the 1980s. But this change in emphasis was in no way a reflection of any lack of commitment to price stability. Rather it reflected the instability in velocity which arose from the liberalisation of our financial markets at the beginning of the decade. This disrupted the relationships which had previously obtained between money and inflation,

Chart 4
Long-term trends of money stock and prices in Germany and the United Kingdom



Monetary growth measured as change from previous year, smoothed with a 10-period mean. M3 for Germany, M4 for the United Kingdom.
Prices measured as change in domestic demand deflators on previous year smoothed with an 8-period mean, and shifted back 10 quarters (Germany) and 6 quarters (United Kingdom).

and afflicted policymakers in the same way that constantly-sounding car alarms afflict innocent passers-by.

The shifts in velocity in the United Kingdom and other countries have been examined in depth in many studies. But Chart 4 is a particularly helpful way to illustrate their impact, especially in contrast with the experience of a country with relatively stable velocity. The upper panel is a reproduction of a chart in the article by Professor Issing to which I referred. It shows the relationship between monetary growth and inflation in Germany, where monetary growth is smoothed by taking a ten-period moving average, while inflation is also smoothed and shifted back ten quarters. The relationship between the two series is surprisingly close and constitutes a strong argument in favour of monetary targets. The lower panel shows M4 monetary growth and inflation in the United Kingdom, where the smoothed inflation rate is only shifted back six periods. The relationship between the two series in the 1970s can be seen to have been reasonably close, although never quite as compelling as that in Germany. But at the beginning of the 1980s, with the marked shift in the velocity of broad money in the United Kingdom, the relationship broke down. More recently, there is some hint that the link between the two series may have reappeared with both the rise and fall in monetary growth in the second half of the 1980s mirrored in the inflation rate, and the Chancellor has recently announced a monitoring range for broad money.

The breakdown of the relationship between money and inflation sparked a search for an alternative nominal anchor for UK monetary policy. That search culminated in our present policy framework, which, I believe, offers the best hope for many years of progressing steadily towards our desired objective of price stability. The cornerstones of this new framework are twofold. First, a newly-specified target for inflation. And second, transparency in the decisions taken in pursuit of that target.

Inflation targets are not a new concept, but they have been applied only relatively recently—and with some success. In practice, of course, they are equivalent in the long run (for a given rate of potential output growth) to a nominal income target which has been proposed by a number of distinguished economists. An inflation target which was imposed irrespective of the source of short-run inflationary pressures, or in disregard of the short-run output costs of disinflation would be undesirable. But the target announced last year—1%–4% throughout the lifetime of this Parliament—is clearly both necessary and feasible.

The importance of transparency in decision-making rests on the belief that the credibility attaching to the monetary authority is an important determinant of the output costs of disinflation. This belief is at the heart of decisions to confer independence on central banks. But in the absence of such independence it is still possible to build a reputation by openly displaying the necessary competence and resolve. This we have been asked to do through the publication of a regular quarterly Report on inflation. This document, the first issue of which was published in February, and the next issue of which will be published in May, will be a very visible demonstration of our understanding of inflation, and thus our *competence* as economic analysts. More than that, it will be a visible demonstration of our *resolve* to signal when remedial policy action is required.

The *Inflation Report* is not a short document, and exponents of some of the more simple-minded approaches to inflation determination may find it altogether too detailed. But our experience in the United Kingdom has shown us the folly of searching for simple solutions. Certainly, our view of inflation in the long run is essentially straightforward: monetary growth determines inflation. But we are as one with the Bundesbank in believing that this mapping is not necessarily one to one. The short-run path of inflation is determined by many factors—world commodity prices, the exchange rate, and the degree of underutilisation in the economy. In the absence of any monetary accommodation, these factors will tend to determine the *speed* with which changes in monetary policy are translated into changes in inflation.

The second difference between the two institutions, and one to which many commentators attach great importance, is the contrast between the statutory independence of the Bundesbank and the constitutional ambiguity of the Bank of England. Most central banks were created *ab initio* during this century, and their constitutions reflect an explicit view of their functions. The Bank of England has a much longer history. And the passage of the Bank of England Act in 1946 is remarkable for the virtual absence of any debate about what the functions and role of a central bank might be. As John Fforde, in his recent official history of the Bank, put it,

> 'In the United Kingdom no such need was felt. For the central bank was there already, the evolutionary product of growth over time. For reasons lying deep in British habits of self-satisfaction, these circumstances of prolonged birth were widely presumed to endow the result with a special virtue, enhanced with a flavour of prestige, power, expertise and mystery' (Fforde, 1992, page 4).

Fforde goes on to discuss

> '. . . a monetary constitution whose central Act remained eccentrically devoid of any reference to the wider purposes and responsibilities of central banking' (Fforde, 1992, page 13).

And, as he documents, within the Bank only Humphrey Mynors, Adviser to the Governor and a former Cambridge Economics Fellow, raised the issue of the statutory responsibilities of the Bank. It is interesting to note that some observers from overseas expressed reservations about the 1946 settlement. For example, Graham Towers, the Governor of the Bank of Canada at the time, wrote to Keynes in September 1945 with the view that:

> 'The half-way arrangement under which the central bank is neither a department of government pure and simple, nor directly responsible to the public for its actions, may contain the worst elements of both worlds' (Fforde, 1992, page 781).

Before the 1946 settlement the Bank did have greater independence, if no more clarity, as to its main responsibilities. Montagu Norman, ever the master of ambiguity, believed in the independence of central banks. And he developed some useful ploys in dealing with government. He once fainted in the arms of the Chancellor of the Exchequer—thus literally disarming the opposition.

The role of the central bank and its relationship with government should not be left to chance. Custom and practice are all very well, but they are no substitute for thought and explicit design. Whether the time is ripe for a careful reappraisal of the position and functions of the Bank of England is a question I leave to others. No other central bank offers a blueprint for the United Kingdom—institutional change must reflect varying circumstances—but the experiences of others, and especially of the Bundesbank, do provide crucial insights into what central banks can and cannot do. For the moment the Bank of England has a very clear remit for its new Governor, a framework for monetary policy at the heart of which lies an explicit inflation target, and the responsibility of publishing an *Inflation Report* which contains the Bank's own judgment on progress toward meeting the inflation target. All three features are innovations for monetary policy in this country.

Lessons and conclusions

Whatever the powers and responsibilities that a central bank may acquire, it should never forget that a successful central bank is like a good football referee. Inconspicuous for most of the time, thus allowing the game to flow, but not afraid to take centre stage when a difficult decision is necessary. It cannot rouse the players to a fine performance—only supply-side reforms can do that—and occasionally it may need to show a red card to cool things down. But, in the end, the central bank is doing its job well when no-one notices that it is there, maintaining stability and allowing the players—economic agents—to display their skills. Eliminating macroeconomic instability is the principal aim of a central bank. That is not always straightforward, as the Bundesbank has discovered in dealing with the consequences of unification. But it is a necessary condition for economic success.

And it is this shared commitment to stability which provides the real basis for European monetary co-operation. The differences of form, structure and organisation of our two institutions are secondary to the fundamental intellectual conviction that good governance of the economy goes hand in hand with price stability. And no movements in markets can undermine the spirit of co-operation which flows from that common conviction.

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