

Review of monetary targeting in 1997-8 and more detailed definition of the monetary target for 1998

At its meeting on December 18, 1997, the Central Bank Council of the Deutsche Bundesbank decided to adhere to its monetary targeting for 1997-8, which was announced a year ago. That decision provided that the money stock M3 was to expand at an annual rate of about 5% in the course of 1997 and 1998, respectively. The Central Bank Council additionally set a target corridor of 3% to 6% for 1998.

The Central Bank Council's decision to review its monetary targeting in 1997 and 1998 and to define the monetary target for 1998 in more detail reads as follows:

"The Deutsche Bundesbank will continue to conduct its monetary policy in such a way that price stability is safeguarded and, at the same time, the monetary conditions for lasting economic growth remain in place. To this end, the Bank considers it appropriate to adhere to the two-year targeting agreed upon in December 1996, which envisages an expansion of the money stock M3 at an annual rate of approximately 5% in the course of 1997 and 1998, respectively. The slowdown in monetary growth, which the Central Bank Council deemed necessary upon reviewing its target in July 1997, has since materialised. In order to give the markets a guideline for the acceptable pace of further monetary expansion, the Bundesbank is additionally setting a target corridor of 3% to 6% for 1998, i.e. from the fourth quarter of 1997 to the fourth quarter of 1998.

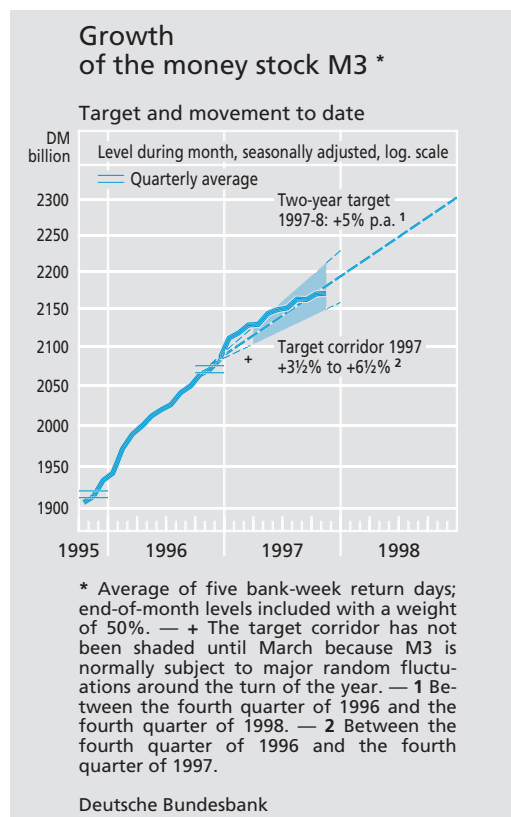
In defining its monetary target for 1998 in more detail, the Bundesbank is setting a clear stability signal. The target corridor has been brought down somewhat against this year's 3½ % to 6½ %. Thus, the Bundesbank is taking due account of the economy's supply of liquidity, which still tends to be quite abundant. It is furthermore demonstrating its intention to prevent the creation of a monetary potential for inflation in the run-up to Stage Three of European monetary union. The target corridor of three percentage points, the width of which has remained unchanged vis-à-vis 1996 and 1997, expresses the still fairly high degree of volatility of shorter-term monetary growth.

The Bundesbank is thereby abiding by its monetary targeting strategy, as well as by the money stock M3 as the key benchmark variable for its monetary policy, also in view of the special underlying conditions in the run-up to Stage Three of European monetary union. It is nevertheless well aware of the fact that in the second half of 1998, it will have to take a broader view of the area of European monetary union, which will be known by then.

With today's decision, the Bundesbank creates the conditions that will allow the European Central Bank to carry on smoothly from the Bundesbank's monetary targeting."

Review of monetary targeting in 1997-8

In view of the special underlying conditions in the run-up to Stage Three of European mon-



etary union, at the end of 1996 the Bundesbank extended the time horizon for its monetary targeting to two years. This decision provided that the money stock M3 was to expand by approximately 5 % in 1997 and 1998, respectively. For 1997, the Bank additionally set a target corridor of 3½ % to 6½ %. This target will in all probability be fully achieved, even if the entry into the monetary target period of 1997 was difficult. The money stock M3 expanded vigorously at the beginning of the year, especially as a consequence of a substantial statistical overhang at the end of 1996. At that time, the changes in the tax treatment of the purchase of property, particularly in eastern Germany, that came into effect in 1997 resulted in anticipatory effects which triggered a high level of borrowing in the private sector. Afterwards, the

1997 monetary
target achieved

monetary dynamism weakened perceptibly, albeit with fluctuations from month to month. In June the money stock M3 entered last year's target corridor of 3½% to 6½%, which it had consistently been overshooting in the preceding months. Seasonally adjusted and extrapolated to yield an annual rate, it still exceeded its average level of the last quarter in 1996 by 5.1% in October, and by 4.7% in November. The total result for the fourth quarter of 1997, too, is expected to be around the target corridor's centre. Hence, after the 1995 undershooting and the 1996 overshooting, not only the monetary target for 1997, but probably also the multi-quarter growth rate that is consistent with production potential of approximately 5%, will be achieved.

*Overall
benchmark
figures*

In December 1996 the Bundesbank furthermore announced that, at the end of 1997, it would define in more detail the monetary growth range that will be acceptable in 1998, thus giving the public a guideline. The starting point for this is the review of the overall benchmark figures, which was the basis of the monetary targeting for 1997-8.

In line with the potential-oriented approach, they were assumptions of the growth of real production potential, the medium-term price movements and the trend in the "velocity of circulation" of money. To be more precise, the Bundesbank assumed a growth of real production potential of just over 2% for the whole of Germany in each year, a medium-term price assumption of 1½% to 2% and one additional percentage point for the negative trend in the "velocity of circulation" of

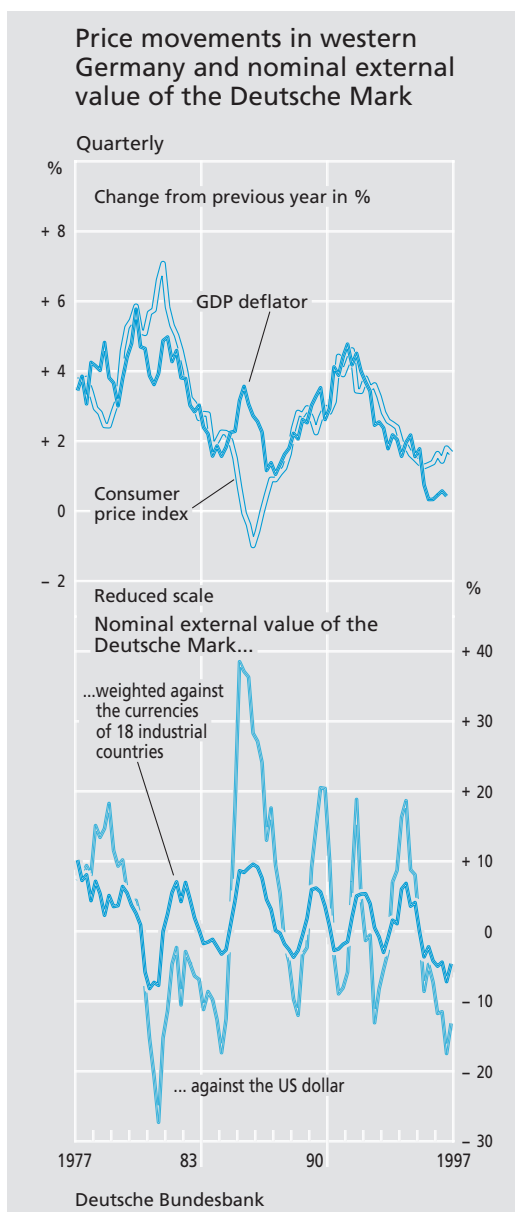
money. At the end of 1996, the sum of these benchmark variables yielded an expansion of the money stock M3 of around 5% on average and in the course of 1997 and 1998; this expansion was consistent with production potential.

As things now stand, the growth of real production potential must be expected to be slightly lower than originally estimated; the updated estimates for 1997 and 1998 assume an average expansion of 2%. This correction is mainly attributable to the fact that the investments of the recent past were reduced slightly in the revision of the national accounts presented in September 1997. The production potential's correction, however, may be influenced by margins of error and must therefore not be overrated, especially as the common methods of estimating the potential probably do not sufficiently reflect the progress in productivity made possible through the more flexible employment of the factors of production. Furthermore, the increase in the real production potential of the whole of Germany is likely to be somewhat higher again this year than in 1997. This is due to the projected revival of business investment against the background of positive expectations regarding export and output in the manufacturing industry, with simultaneously rising corporate profits and a continued increase in capacity utilisation.

*Production
potential*

In December 1996 the Central Bank Council lowered its medium-term price assumption (unchanged since 1985) from 2% to between 1½% and 2%. This step was taken on the grounds of the expectation that the

*Medium-term
price
assumption*



price increase would continue to be moderate. Indeed, last year the change of all comprehensive price indices for the whole of Germany remained below or near the upper limit of 2%. Although in the summer the consumer price index had increased temporarily by slightly more than 2%, which was attributable to rising import prices and the raising of the statutorily fixed prices, subsequently

the price rise decelerated again. For all of 1997, consumer prices increased by 1.8%.

The rise of the GDP deflator was considerably lower. In the first three quarters of 1997 it was just ½% compared with the year before. For one thing, this very low figure and the disparity between it and the consumer price index reflect the fact that the cost of the other components of domestic expenditure has risen much less sharply than that of private consumption. For another, the direct adverse reaction of the GDP deflator to the sharp rise in import prices in the course of 1997 had an impact here. Apparently it was not possible to roll over the increased import prices directly, due to the sluggish domestic economic activity and the competitive export business. Taken by itself, this has had a restraining effect on enterprises' profit margins, thus "distorting" the deflator downwards and understating the cost pressure that is hampering domestic output. This year the GDP deflator and the consumer price index are likely to diverge again, albeit to a lesser extent. In the long term, however, they more or less move in unison. Therefore, temporary distortions are of no relevance when determining the medium-term price assumption.

Consumer prices are likely to increase moderately this year, too. Unit labour costs, in particular, which will presumably decrease slightly once again, as well as competition in internationally traded goods, which has continued to become fiercer owing to the sharp depreciation of some of the Asian currencies, are expected to contain the price rise further.

Increase in the value-added tax

Nevertheless, the price forecasts slightly exceed the levels reached so far. This is particularly valid following last year's decision to raise the standard rate of value-added tax from 15 % to 16 % as of April 1, 1998. Taken by itself, this step is likely to result in an increase in the consumer price index by around $\frac{1}{3}$ percentage point (on an annual average). The purely mathematical consequences of the increased value-added tax rate for the price trend, which will tend to be slight, ought to have already been covered by the medium-term price assumption of 1½ % to 2 % included in the monetary target. However, it is essential to prevent the inflationary momentum of the value-added tax increase from triggering a multiplicative inflationary process. To that extent, the increase in the value-added tax rate has not prompted the Bundesbank to raise its medium-term price assumption, which is a definitive expression of its price stability target.

"Velocity of circulation"

The add-on for the trend decline in the "velocity of circulation" of money can continue to be set at one percentage point per annum. The updated trend calculations, which include the latest revision of the potential estimation and the development of the money stock M3 in 1997, confirm this order of magnitude.

Retaining the two-year targeting for 1997-8

In view of the merely slight change in the key benchmark figures compared with December 1996, the Bundesbank has decided to retain its two-year targeting of approximately 5 % per annum. The slight revision of the production potential, which – as previously mentioned – is subject to general margins of

error, is not a sufficient reason to lower this targeting. Nevertheless, as things now stand, the 5 % mark seems generous, if anything.

More detailed definition of the monetary target in 1998

The economy's liquidity supply, which is also taken into account by the Bundesbank in defining its monetary target in more detail, continues to tend to be abundant. Although the money stock M3 expanded in line with the target in the course of 1997, its annual average increase of just over 6 % was markedly sharper than had been aimed for, due to the sharp growth at the beginning of the year. Measured on the basis of longer-term scales, the economy's liquidity supply does not appear to be tight, either. Thus, the monetary situation indicates an expansionary stance of monetary policy. The commonly-used financial market indicators confirm this impression. The nominal and the real money market and capital market interest rates are below their multi-year average values. In addition, last year's depreciation of the D-Mark's external value contributed to a relaxation of the general monetary conditions.

Liquidity supply abundant

In defining its monetary target for 1998 in more detail, the Central Bank Council took due account of its two-year targeting of approximately 5 %, which tends to be generous, and of the abundant liquidity supply, and lowered the target corridor for the acceptable monetary growth by $\frac{1}{2}$ percentage point compared with the year before. According to this decision, the money stock M3 is to ex-

1998 target corridor of 3 % to 6 %

pand by 3 % to 6 % from the fourth quarter of 1997 to the fourth quarter of 1998. This sets a clear stability signal. Thus, the Central Bank Council continues to abide by its policy stance of the summer of 1997, when on reviewing its target it had deemed a further slowdown in the monetary growth necessary. This slowdown has since materialised. The money stock is currently on a path of moderate growth. The corridor width of three percentage points in existence since the 1996 monetary target was set is being retained. Thus, the Bundesbank is taking account of the short-term volatility in monetary trends, which continues to be rather high.

Monetary targeting in the run-up to monetary union

*Strategy of
the ECB*

With its monetary target for 1998, the Bundesbank has set an annual monetary target for the twenty-fourth time in a row and, in all probability, for the last time ever. Continuity in the monetary targeting policy has been possible because the long-term relationships between monetary and price trends have remained sufficiently stable in Germany. In the larger European currency area, too, the empirical prerequisites for a monetary targeting strategy appear to exist. Monetary targeting has some advantages over alternative strategies which make it particularly suitable for pursuing a policy primarily aimed at maintaining monetary stability.¹ Therefore, the Bundesbank intends to incorporate monetary targeting into the policy of the European Central Bank (ECB) wherever possible. With its monetary target for 1998, it has created

the conditions that will allow the ECB to carry on smoothly from the tried and tested monetary targeting policy practised in Germany. In the second half of this year, the ECB Council will take its decision on which monetary policy stance is to be adopted in Stage Three.

The monetary target for 1998 is also marked by special circumstances insofar as the underlying conditions for German monetary policy will change in the run-up to Stage Three of European monetary union. This is particularly valid for the interim period, which will start with the selection of the participating countries early in May and will end with the launch of monetary union at the beginning of 1999. Cooperation among the European national central banks can be expected to intensify over the course of this year, initially under the aegis of the European Monetary Institute and then under that of the ECB. A formal arrangement for this is not necessary, however. Monetary responsibility will remain with the national central banks during the interim period. German monetary policy continues to be subject to the mandate of the Bundesbank Act.

*Intensified
co-operation*

With the monetary target for 1998, the Bundesbank has reaffirmed its position of adhering to its anti-inflationary stance and to its strategy until the start of monetary union. The continuation of its stability policy is also in line with the requirements of cooperation in monetary policy with the partner central banks. This cooperation must be geared towards avoiding the creation of a potential

¹ See also Monetary policy strategies in the countries of the European Union, page 33 ff. of this Monthly Report.

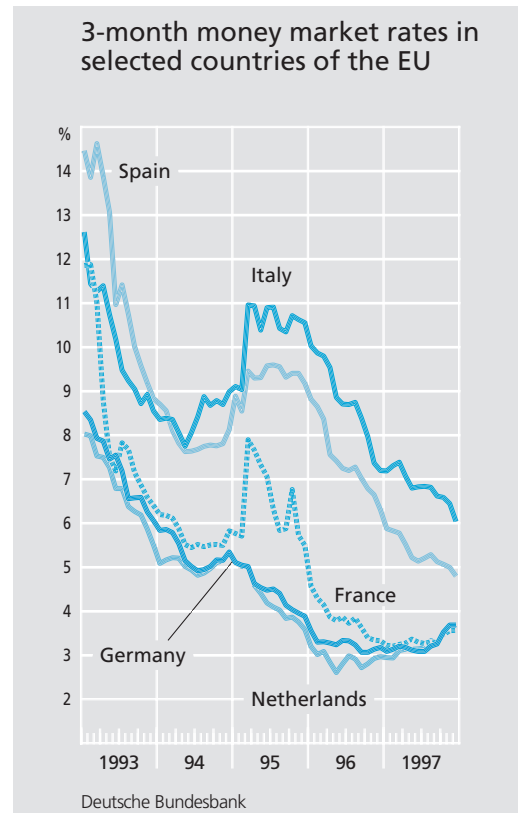
for inflation during the run-up to monetary union in order to facilitate the ECB's start. Furthermore, a homogeneous policy of the national central banks that is uniformly geared towards the objective of price stability is likely to be suitable for strengthening confidence in the future common monetary policy and for preventing turmoil in the financial and foreign exchange markets.

European aspects gaining in importance

The Bundesbank is well aware of the fact that in the second half of 1998, it will have to take a broader view of the area of European monetary union, which will be known by then. European aspects will have to be included in its analysis to a greater extent. However, the Bundesbank has never automatically based its activities on monetary growth; on the contrary, it has examined the signals emanating from the money stock in the context of a broadly-based analysis of all data that are relevant to inflationary trends. They include information from the European setting that is relevant to monetary policy.

Interest-rate convergence

In line with increasing interdependence in Europe, this year an intensified convergence of official interest rates will occur, if this has not been the case already – such as in the “hard-core countries”. This convergence, however, does not necessarily have to materialise prior to or at the very beginning of the



interim period. On the contrary, during that time exchange-rate fluctuations and interest-rate differentials, which would be limited in scope, may still occur. The central banks will have to feel their way towards a common interest-rate level. The overall economic situation in the future currency area will have a decisive impact on the appropriate level of official interest rates. Provided that the markets will expect a high degree of stability of the euro, the interest-rate level is likely to be geared to those of the “hard-core countries”.

