Review of monetary targeting in 1997-8 and of the 1998 monetary target

At its meeting on July 23 the Central Bank Council of the Deutsche Bundesbank confirmed its monetary targeting for 1997-8 and the monetary target for 1998. With the money stock M3 having grown in accordance with the target over the course of this year, the Bundesbank will direct its policy in the coming months, too, towards growth which is consistent with production potential. The Central Bank Council reaffirmed that it continues to consider the money stock M3 a suitable reference variable for German monetary policy. In addition – as already announced in December 1997 – it will focus increasingly on the future European monetary union in the next few months. In this connection, monetary growth is of particular importance.

The Central Bank Council's decision on the review of monetary targeting in 1997 and 1998 and the monetary target for 1998 reads as follows:

"The Deutsche Bundesbank abides by its monetary orientation, as adopted in December 1996, which provides for an expansion of the money stock M3 in the course of 1997 and 1998 by about 5 % per annum. The target corridor of 3 % to 6 % additionally set for 1998 is likewise retained unchanged.

So far this year, the money stock M3 has grown in line with the target. The Bundesbank continues to be intent on keeping monetary growth on a path consistent with production potential in order, in the light of European monetary union, to prevent a monetary inflation potential from emerging.

Hence the Bundesbank is adhering to its strategy of monetary targeting and to the money stock M3 as its benchmark variable for monetary policy. As already announced in December 1997, in the further course of the year it will focus its gaze increasingly on the entire area of the European monetary union. In this connection, monetary growth deserves particular attention."

Review of the benchmarks

Production potential

The review of monetary targeting for 1997–8 and of the target corridor for 1998 is based, as usual, on the macroeconomic benchmarks which determine the medium-term potential-oriented money stock expansion. These are the growth of real production potential, the medium-term price assumption and the trend velocity of circulation of money. From the present perspective, the increase in real production potential, which in December of last year was estimated to average 2 %, can be retained. At the time, the potential estimation had been revised downwards slightly compared with December 1996.[1] The revision, however, was within the range of the usual errors in the estimations and was therefore not regarded as a sufficient reason for lowering the two-year target for monetary growth of about 5 % per annum. Moreover, potential growth is likely to be somewhat stronger than in 1997 as a result of the presumably more buoyant investment activity in the corporate sector in the current year. In the first quarter of this year investment in machinery and equipment grew vigorously. The higher capacity utilisation and the favourable financing conditions continue to contribute to an environment conducive to investment.

Medium-term price assumption

The medium-term price assumption of 1½ % to 2 % was likewise retained. So far this year, price trends have been encouraging. The principal comprehensive price indices showed rates of increase which were below the medium-term price assumption of 1½ % to 2 %. The increase in consumer prices, which, at an average of 1.8 %, had accelerated somewhat in 1997 (1996: 1.5 %), has decelerated again in the current year. Of particular importance in this connection was the easing of oil prices. The further fall in unit labour costs was another factor which has had a price-dampening effect. The raising of the standard value-added tax rate as from April 1, 1998 did slightly stimulate the rise in prices in April and May; thereafter, however, it decelerated. In July consumer prices were up 0.9 % on the previous year. Even though the external factors are unlikely to remain as strong as before, the overall outlook for prices for the further course of this year is favourable. At ½ %, the rise in the GDP deflator against the previous year continues to be lower than the rate of consumer price inflation, even though the gap between the two indices has narrowed slightly. In the longer run, these variables follow a very similar path,

1 See Deutsche Bundesbank, Review of monetary targeting in 1997-8 and more detailed definition of the monetary target for 1998, Monthly Report, January 1998, page 17.

which means the present difference is of minor importance for the price assumption.[2] As it is defined for the medium term, the rate may well fall below the price assumption in the short run. The risk of a deflation, i.e. a persistent fall in the general level of prices, is not discernible at present, even if a possible overstating of actual price movements in the official price statistics is taken into account.

Velocity of circulation

Finally, the add-on of one percentage point for the trend decline in the velocity of circulation of money has been confirmed by updated trend calculations.

Retention of the two-year orientation 1997-8

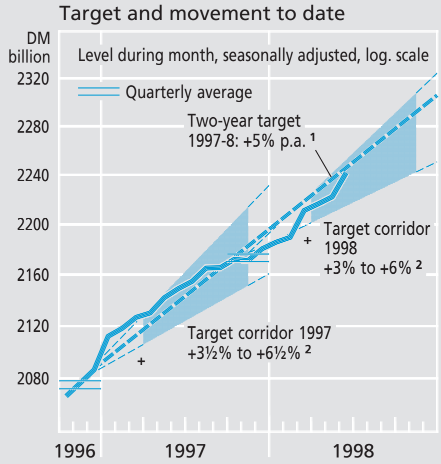
In view of the benchmarks which have remained unchanged from December 1997, the Central Bank Council decided to retain the two-year target of about 5 % per annum. Given the slight downward revision of potential growth at the time, this nevertheless continues to tend to be on the liberal side.

Confirmation of the monetary target for 1998

Last December the Central Bank Council, moreover, specified the monetary target for 1998. It decided to lower the target corridor by half a percentage point to 3 % to 6 % compared with 1997. By doing so, it also took into account the underlying monetary position at the end of the year, when liquidity tended to be in ample supply. It is true that over the course of the year, monetary growth was on target, but owing to the steep rise at the beginning of 1997, the average annual growth of the money stock M3, at just over 6 %, exceeded the rate initially envisaged. From the present perspective, the assessment made at the end of last year still holds true.

Growth
of the money stock M3 *

Target and movement to date



* Average of five bank-week return days; end-of-month levels included with a weight of 50%. — + The target corridor has not been shaded until March because M3 is normally subject to major random fluctuations around the turn of the year. — **1** Between the fourth quarter of 1996 and the fourth quarter of 1998. — **2** Between the fourth quarter of the previous year and the fourth quarter of the current year.

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The Central Bank Council therefore confirmed the monetary target for 1998.

Monetary developments in the first half of the year

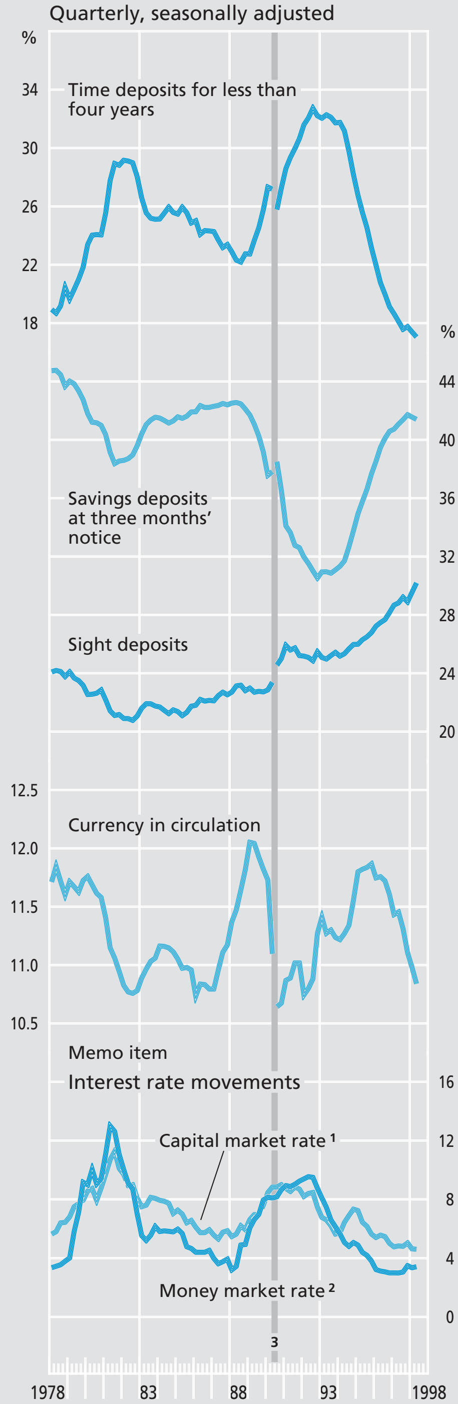
Monetary growth on target

Entry into this year's monetary target period posed no problems. Although the fairly moderate monetary dynamism in the second half of last year has picked up somewhat so far this year, it has remained within the range set by the Central Bank Council. In the short run, however, monetary growth has been subject to fluctuations. A moderate increase in the

2 See also Deutsche Bundesbank, Review of monetary targeting in 1997-8 and more detailed definition of the monetary target for 1998, Monthly Report, January 1998, page 20.

Structure
of the money stock M3

Quarterly, seasonally adjusted



1 Yield on domestic bearer bonds outstanding. — 2 3-month Frankfurt interbank rate. — 3 From June 1990 Germany as a whole.

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money stock M3 at the beginning of the year was followed by strong growth in March; in April and May the rate of expansion slackened, but it accelerated again in June. In June the money stock M3 exceeded its average level in the fourth quarter of 1997 by a seasonally adjusted annual rate of 5.3 %. Compared with the level in the fourth quarter of 1996, M3 rose by a seasonally adjusted annual rate of 4.9 % until June.

Money stock components

Among the money stock components, sight deposits have made by far the greatest contribution to monetary growth so far this year. After falling in the last four months of 1997, they grew at an annual rate of 17 % between January and June. The exceptionally vigorous growth is partly due to the extremely low opportunity cost resulting from the record low interest rates and virtual price stability. The high liquidity preference also owes something, however, to a wait-and-see attitude as far as further developments in the financial markets are concerned. Finally, it probably reflects the strong GDP growth in the first few months of the year. Currency in circulation, which had declined in the second half of 1997, has, on balance, increased somewhat so far this year – with sharp fluctuations from month to month. Even so, the money stock M1, which measures the liquidity which is directly available for transaction purposes, expanded strongly in the first half of the year. Shorter-term time deposits, by contrast, have been run down so far this year. Savings deposits at three months' notice have continued to grow moderately, with the growth once again being accounted for solely by higher-yielding special saving facilities.

Purchases of money market fund certificates ...

Domestic non-banks have increased their portfolios of money market fund certificates over the course of this year, after having sold such certificates on balance in the two preceding years (1997: – DM 7.7 billion, 1996: – DM 11.8 billion). Between January and June they bought DM 6.2 billion of money market fund certificates. In view of the low level of capital market rates and the flattened yield curve, this form of assets currently seems to have become somewhat more attractive again. Investments in money market fund certificates are likely to have taken place at the expense of both M3 expansion and monetary capital formation. Overall, the restraining effects on M3 growth of these purchases would appear to have been limited.

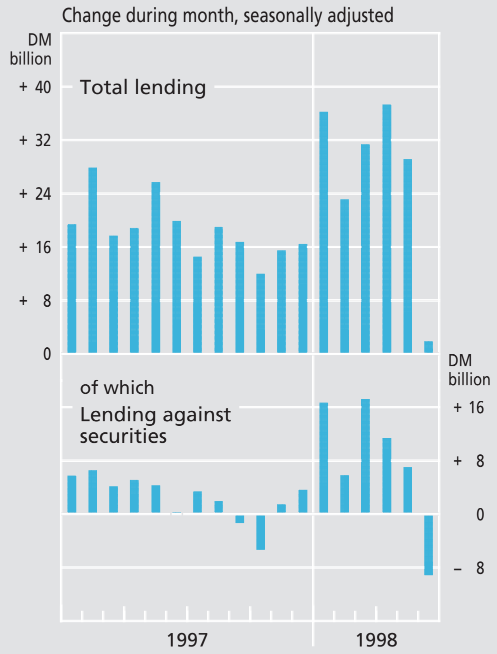
... and investment in the Euro-market foster growth of M3 extended

Over the first few months of this year, Euro-deposits likewise increased strongly. The money stock M3 extended, which includes such deposits as well as money market fund certificates in the hands of domestic non-banks, has therefore grown slightly faster than M3 since the beginning of the year.

Strong credit expansion

The acceleration of monetary expansion so far this year is attributable not least to buoyant lending to the private sector. Lending to enterprises and households went up by a seasonally adjusted annual rate of 8½% in the first half of the year, compared with just over 6% in 1997. However, about one-third of this amount was accounted for by the banks' purchases of corporate securities, notably equities. A major part of such purchases was made in the secondary market and, to that extent, did not imply any new lending to the issuers. If solely direct lending is analysed, the acceleration in credit expansion is much more subdued. Such lending grew at an annual rate of 6% between January and June, following a 1997 rate of just over 5½%. Public sector debt to credit institutions has risen steeply over the course of this year; four-fifths of the increase was accounted for by lending against securities. This reflects in particular a shift in the structure of creditors of securitised government debt. Whereas credit institutions markedly increased their portfolios of government bonds, purchases by foreign investors dropped perceptibly, and domestic non-banks sold government paper, on balance.

Lending to the private sector *



* Lending by credit institutions to domestic enterprises and individuals.

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Further weakening of monetary capital formation

The rather subdued monetary capital formation has also had an expansionary impact on monetary growth. Domestic investors' low propensity to acquire longer-term financial assets at banks, which has been the case for over two years now, has slackened further over the course of this year. Between January and June, monetary capital held with banks grew at an annual rate of just over 2½%, as against just over 4% in 1997. The steep fall in the level of interest rates and the flattened yield curve evidently markedly reduced the attractiveness of both bank bonds and long-term time deposits. In addition, savings deposits at over three months' notice, which have been on the decline since the autumn of 1995, continued to decrease.

Sizeable outflows of funds generated by external payments

Monetary growth, on the other hand, has been curbed so far this year by heavy outflows of funds generated by domestic non-banks' external payments. One contributory factor was that at the beginning of the year enterprises strongly built up their Euro-deposits again – following the usual end-of-year reduction. Another factor was that domestic non-banks once again purchased large amounts of foreign securities.[3] As in 1997, they thus shifted some of their longer-term asset acquisition abroad. To that extent, the balance sheet counterpart of the fall in the banking system's net external position is not only a slowdown in monetary expansion but also a weakening of monetary capital formation.

Outlook for monetary growth in the further course of the year

On the whole, monetary developments so far this year have been in keeping with the Bundesbank's target. The Bundesbank continues to strive to keep monetary growth on a path that is consistent with potential in order to avoid, with a view to European monetary union, the build-up of a monetary inflation potential. From the present perspective, the chances that this year's monetary target of 3% to 6% will be met are fairly good. Nevertheless, major fluctuations in monetary growth in the coming months cannot be ruled out. The development in lending to the private sector will depend not least on the further course of business activity. Monetary capital formation might remain low given continued low interest rates. The extent to which this will impact on monetary growth will depend in particular on whether it will be offset by corresponding shifts of funds abroad.

Underlying monetary policy conditions and monetary policy strategy in the interim period

Special underlying conditions in the interim period

What is known as the interim period began with the European Council's decision regarding the selection of countries participating in the euro area which was taken on the first weekend in May this year. During this period the Bundesbank, like its partner central banks in EMU, is faced with special underlying conditions. Until the end of 1998 the national central banks will remain responsible for monetary policy. However, owing to the usual time lags, the monetary policy decisions taken during that period will only exert their full impact in one or two years' time, and hence in Stage Three. The monetary policies of the central banks of all EMU states will therefore affect the euro area as a whole.

3 Between January and June they purchased DM 87.6 billion of foreign shares, DM 8.7 billion of foreign bonds and DM 15.7 billion of foreign investment fund certificates.

This causes a need for even more intensive cooperation with the other central banks of the participating countries, in particular in the Governing Council of the ECB. This cooperation, and the monetary policy of each individual central bank, will have to be based primarily on EMU-wide considerations geared to the stability requirements of the euro area as a whole. Monetary policy will be less and less able to take account of national special features in the trend of economic activity during the interim period.

M3 continues to be a key reference variable

Nevertheless, even under these circumstances the money stock M3 remains a key reference variable for German monetary policy. The Central Bank Council underlined this by confirming its monetary targeting for 1997-8 and the monetary target for 1998. In terms of GDP, Germany makes up about one-third of the euro area, which means the outlook for inflation in Germany significantly determines price developments in the monetary union as a whole.

Monetary growth at the forefront of EMU indicators, too

However, in the further course of the year the Bundesbank will increasingly include EMU-wide indicators in its monetary policy analysis. Monetary aggregates deserve particular attention in this connection. They are closely related with inflation and are therefore likely to play an important part in Stage Three as well – irrespective of the specific monetary strategy of the ECSB. Assessment of monetary growth in the euro area as a whole, however, still poses some difficulties at present, as no common "EMU money stock" has been defined yet. This issue will presumably soon be resolved. Until then, corresponding figures for EMU as a whole can only be derived from national monetary aggregates. The Bundesbank has computed such makeshift constructs for a broadly defined money stock M3H (M3 harmonised) and for a narrow monetary aggregate M1.[4]

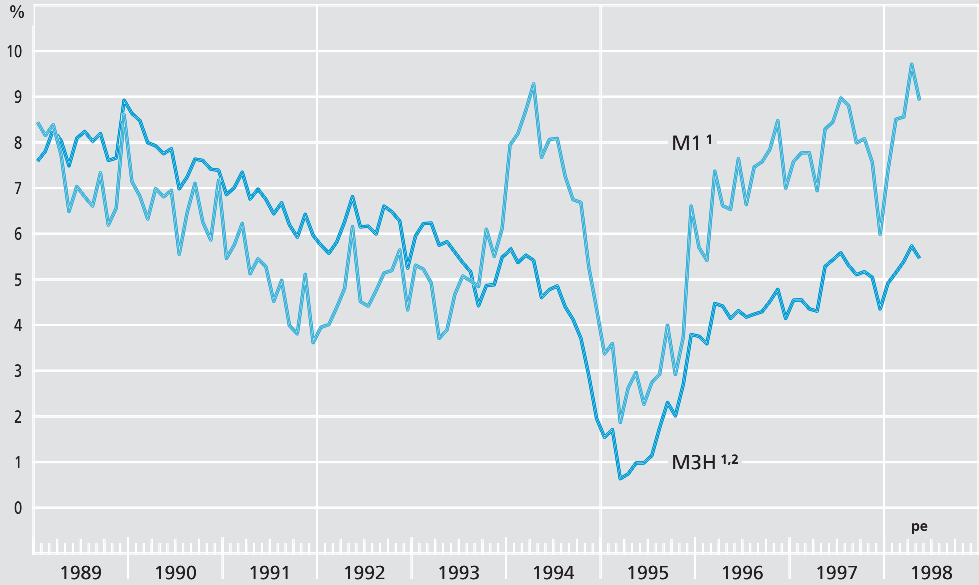
Money stock M3H

The national M3H definitions on which the EU central banks had agreed in the early nineties are generally used as a basis for the M3H aggregate for the euro area. This aggregate comprises, broadly speaking, the "liquid bank liabilities" held at home.[5] The precise details of the M3H definitions of the individual countries differ, however, in order to be able to take the special features of the national financial structures into account. Moreover, M3H does not include the cross-border investments in EMU. In ascertaining the EMU aggregate, the Bundesbank first converts the national series into Deutsche Mark (using the consumer parities of 1993). Because a fixed exchange rate has been chosen, the dynamism of the original series is retained, and the growth rate of the EMU aggregate is not influenced by exchange rate movements. The second step is to determine the geometric mean of the national M3H series (in Deutsche Mark) – weighted with the nominal GDP shares of 1993.[6] The growth rates calculated from this index series correspond to the weighted arithmetic mean of the growth rates of the national series. The EMU-wide M3H growth calculated in this way is there-

4 These are not official ESCB series.
5 For Germany, M3H comprises, in addition to M3, bank savings bonds with a maturity of up to one year.
6 This means that the national money stock series are exponentiated by the respective GDP shares of 1993 and then multiplied by one another.

Monetary growth in EMU *

End-of-month levels, change from previous year in %



* Sources of national money stock series: BIS and national statistics. First the monetary aggregates of the individual countries were converted into Deutsche Mark on the basis of consumer parities of 1993, and then geometric means were calculated using nominal GDP weights of 1993 (index procedure). — **1** EMU excluding Luxembourg. — **2** Until the end of 1993 excluding Ireland as well.

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fore in line with the notion of a weighted average using the national money stock rates of change. When interpreting the findings, however, one must consider that, depending on the national series used as a basis and on the aggregation method applied, slight differences in the calculated growth rates may occur when preparing euro aggregates. The differing approaches do not, however, affect trends (provided that fixed exchange rates are used).

Econometric studies by the Bundesbank have shown that the long-term money demand for M3H is stable. Moreover, a lead of M3H over prices was ascertained. M3H therefore seems to be well-suited as a broad reference variable for the interim period. However, owing to the differences in definitions across countries and the exclusion of cross-border holdings of assets within EMU, M3H is not suitable as a monetary aggregate for Stage Three.

M1 aggregate for EMU

In order to be able to make a more comprehensive assessment of monetary conditions throughout the euro area, in addition to the money stock M3H a narrow aggregate M1 for the euro area was calculated which is used to assess the funds held directly for transaction purposes. The preparation of the euro aggregate is based on the national M1 series which in all countries comprise currency in circulation and sight deposits. For the aggregation, the same method as for M3H was used.

Acceleration of monetary growth in EMU

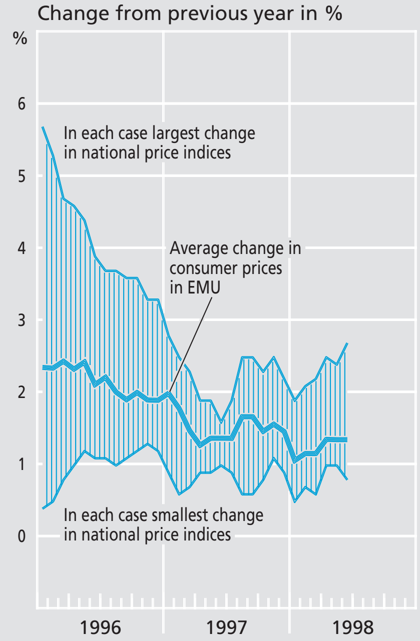
Measured in terms of the monetary aggregates M3H and M1, the overall pace of monetary expansion in the future EMU has accelerated since the beginning of the year. In May (according to provisional and partly estimated figures) the money stock M3H exceeded its level in the previous year by 5½%, following an increase of only 4½% in the course of 1997. M3H growth has varied among the individual EMU countries. It has been particularly vigorous so far this year in Italy and Ireland; in France, too, growth has accelerated markedly over the course of this year, starting from a moderate path. In the previous course of the year the money stock M1 has increased more rapidly than the broad aggregate. In May (according to provisional and partly estimated figures) it exceeded its level in the previous year by 9%, compared with 6% in December 1997. The low opportunity cost of holding cash as a result of further declines in interest rates in some cases and low inflation rates seem to have encouraged M1 growth in a number of countries.

Real EMU indicators ...

Besides monetary growth, overall economic conditions play an important part in the assessment of the outlook for inflation in the euro area. At present, ongoing economic analysis for the consolidated euro area is based only on a section of the widely used indicators, such as the real GDP aggregate for the five major EMU countries (Germany, France, Italy, Spain and the Netherlands), industrial output, the standardised unemployment rate, the harmonised index of consumer prices, producer prices calculated on a national basis and business surveys for the EMU area as a whole. Moreover, further indicators are available for individual countries, such as on the components of the use of GDP.

Movement of consumer prices in EMU *

Change from previous year in %



* Harmonised indices of consumer prices.

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... show economic recovery and favourable price trends

If economic conditions in EMU are assessed using the data currently available, one finds that the economic upswing in the EMU countries has continued rapidly following the turn of 1997-8. At the same time, the basis of the cyclical upswing has broadened. Domestic demand – i.e. both private consumption and investment activity – has gathered pace, whereas the importance of exports as an engine of economic activity has declined slightly in importance. The objective of price stability has currently virtually been reached in EMU as a whole; in June, consumer price inflation was 1.4% against the previous year.

Price outlook at the end of the year will determine interest rate convergence

Monetary policy makers will closely watch monetary and real economic conditions in the euro area as a whole in the coming months. The further development of the outlook for inflation will also determine the interest rate to which the central bank rates of the individual EMU countries will have converged by the end of the year.