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Monetary Policy: Does Independence Make a Difference? – The German Experience*

I. Introduction

If countries are ranked in respect to their degree of price level stability since the collapse of the Bretton-Woods-System the list is topped by Switzerland and Germany – two countries with relatively independent central banks. Of course, the independence of central banks may not be the only explanation for this result. Thus, one has to take into account that public aversion against inflation is probably stronger in these two countries, partly due to Germany's experiences. We shall argue, however, that at least in the case of the Federal Republic of Germany the independence of the central bank has been an additional factor for the relatively low German inflation rates, although it should not be forgotten that the present rate of inflation in Germany is still far from representing price level stability.

The present paper is organized in two parts. The first part, titled: «Independence: what for?», deals with the role of monetary policy in solving the assignment problem. It will be shown that the adjustable peg system of Bretton Woods prevented a rational solution to the assignment problem in the Federal Republic.

In the second part with the title: «Independence: from whom?», we analyse the dependence of the German central bank from domestic and foreign governments in a brief historical survey stretching back till 1875. It will be argued – inter alia – that both the hyperinflation of 1922/23 and the great depression starting in 1929 have been the result of monetary mismanagement by the central bank and cannot be attributed to government interference with monetary policy.

II. Independence: What for?

As in many other countries the Government of the Federal Republic of Germany is committed to simultaneously pursuing the macro-economic goals of «price level stability», a «high level of employment» and «external economic equilibrium». The relevant

* Paper presented to the General Meeting of the Mont Pèlerin Society at Hoover Institution, Stanford University, September 7–12, 1980.

laws also mention «adequate economic growth» and limit the choice of instruments to those compatible with the framework of a market economy[1].

When the German Economic Council (Sachverständigenrat) was first confronted with the magic policy triangle of price level stability, full employment and external equilibrium, it came out (in 1964) in favor of flexible exchange rates (for external equilibrium and as a precondition for domestic price level stability) in a report that was published under the programmatic title «Stable Money – Steady Growth». However, it must be admitted that the Council failed to present a clear-cut analysis of the policy assignment problem with respect to the domestic targets of price level stability and full employment. This assignment problem stems from the theorem (first stated by Tinbergen) that the number of (suitable) instruments must (at least) be as large as the number of separate targets. The problem is boiling down to the question: who has comparative advantage for securing price level stability and who should be responsible for attaining and maintaining full employment?

In the following we shall consider three possible solutions to the assignment problem:

- The central bank is responsible for full employment, whereas the responsibility for a stable price level rests with trade unions.
- The central bank's policy is directed towards both targets.
- The central bank is made responsible for achieving the target of price level stability; the target of full employment is left to the wage and pricing policy of labor and business.

The rule that labor unions are responsible for price level stability usually appears plausible to laymen who feel that costs determine prices and who do not visualize «demand-pull» inflation resulting from an overly expansionary monetary policy. But will an assignment which places responsibility for price level stability with the trade unions be efficient? Why should trade union leaders be content with low wage increases when they have reasons to anticipate that the central bank, in pursuit of the full employment goal, will accommodate whatever wage increase has been decided upon? There may be two reasons for a positive answer:

- First, there may exist a combination of high public aversion against inflation and a desire of trade union leaders to gain status and to assume public responsibility. Experience shows, however, that one can hardly expect that trade unions will consider price level stability to be their principal objective. When membership is voluntary and when unions have to rely on membership contributions, they then can hardly refrain from pressing for wage increases in excess of what is compatible with cost level stability.
- Second, there is the possibility that organized labor is striving for political power and concessions (like the introduction of codetermination in Germany) which induce unions to sacrifice short-term wage gains for syndicalist objectives. But such a political bargain will contribute to the target of price level stability for a limited period only, while it is likely to entail a lasting erosion of the market economy.

An assignment which places responsibility for price level stability with autonomous labor unions must, therefore, be regarded as inefficient in the medium run.

[1] See «Gesetz über die Bildung eines Sachverständigenrates zur Begutachtung der gesamtwirtschaftlichen Entwicklung» (Aug. 14, 1963) and «Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft» (June 8, 1967).

It is worthwhile to note, however, that a moderate wage policy may be a precondition for price level stability in an adjustable peg regime. Under such a system, the assignment problem cannot be solved in a simple and rational way. For a small open economy (or for a medium size economy which does not supply the dominant international money) the reasoning is as follows:

The domestic price level is determined by the foreign price level and the exchange rate, if not in the short run then at least in the medium run. To prevent an imported inflation a revaluation of the exchange rate has to be enacted; but under the adjustable peg system this is only justified when a fundamental disequilibrium in the balance of payments persists, i. e., after a surplus in the basic foreign balance has emerged. Such a surplus which requires that domestic wage and price increases are sufficiently low can be brought about only by permanently teaching labor unions and business that they are responsible for price level stability. This happened in Germany in the late sixties. Despite excess demand for labor – with guest workers filling the gap – union leaders were criticized for pursuing an inflationary wage policy.

Thus, moral suasion and not the system of fixed exchange rates was the true source of wage discipline in those years. The exchange rate system in which the D-Mark faced pressure to revalue against the reference currency would have permitted higher wage increases than those which actually took place.

The more quickly the exchange rate is adjusted after labor unions have been effectively educated to behave as if they had responsibility for price level stability, the more stable will this solution of the assignment problem be. When in 1964 the German Economic Council came out in favor of flexible rates it thought along those lines. This is why at the same time it submitted a formula for a cost neutral wage policy that, incidentally, took account of changes in the terms of trade and in capital costs per unit of output. If the wage formula implies a constant domestic price level, all improvements in the terms of trade (due to exploiting a high income elasticity of foreign demand for the export basket or to a more rapid productivity growth in the international sector) will show up in a real appreciation of the exchange rate. In this model exchange rate policy, thus, ratifies domestic wage policy; and monetary policy is not directed to maintaining the prevailing exchange rate.

If exchange rates are not adjusted quickly enough, wage discipline is bound to collapse. For unions will soon discover that the resulting excess demand for labor causes a strong wage drift and subsequent wild cat strikes. This was the case in Germany in 1969, when labor unions became gradually convinced that they could – and in the interest of external equilibrium should – switch to a balance of payments oriented wage policy.

A solution of the assignment problem which leaves out labor unions and which attributes the twin task (1) of generating (and perhaps even guaranteeing) a high level of employment and (2) of maintaining reasonable price level stability to the Central Bank is bound to produce business cycles of the go and stop type. This can be demonstrated as follows:

Assume a starting position in – what Schumpeter called – «a neighborhood of equilibrium» and that it contains classical unemployment over and above search unemployment[2]. In this case the question comes up whether unemployment should be fought on

[2] Classical unemployment can arise
– when equilibrium wages have fallen below subsistence levels – because of capital destruction, immigration, or excessive population growth – and when minimum wages are introduced as a matter of legislation or social convention;

the wage front or by monetary acceleration. The solution which is most easily adopted is monetary acceleration, and this mainly for two reasons: First, the option of letting unemployment have its impact on wage negotiations or the national wage round is considered to be too time consuming and also has the stigma of lacking compassion. Second, it is difficult to identify classical unemployment as distinct from Keynesian unemployment, since there are always visible cases where an underutilization of the labor force coexists with an underutilization of physical capital (although the explanation can well be that complementary capital, or the jobs incorporated in complementary capital, have been made obsolete exactly by an excessive rise of real wages).

If the central bank fights classical unemployment by monetary acceleration there tend to be positive short-run effects on output and employment. They result from time lags in price and wage adjustments which are due to money illusion or contractual rigidities. It has to be noted that these time lags have probably become shorter in the last few years, because of two reasons:

- Past inflation has reduced the available stock of money illusion so that monetary policy has become less potent as a means of raising the level of employment and capacity utilization above its sustainable trend value. In the same way, inflation and the destruction of money illusion have shortened the time lag between monetary growth and its impact on the price level (more rational expectations).
- Flexibility of exchange rates further shortens this time lag. If monetary authorities expand the money stock for employment reasons, they immediately induce a depreciation of the exchange rate, so that at least import prices will rise more quickly than under fixed exchange rates. The acceleration of monetary growth thus transforms itself earlier into price rises. The destruction of exchange-rate illusion adds to the decline of money illusion mentioned above.

With inflation rates rising above the tolerance level the central bank which feels responsibility not only for employment but also for price level stability has to put the feet on the monetary brake and to engage in a policy of monetary deceleration until at least a partial victory can be claimed on the inflation front. Given the time lag in the effect of monetary policy on prices and wages, unemployment will again rise.

The result is a policy determined cycle. It will start anew once the public has substituted unemployment for inflation as the number one enemy.

Unless labor reacts quickly in moderating wage claims during recessions one must expect inflation rates to rise from cycle to cycle. This is why the German Expert Council in the 1967 recession advocated monetary-fiscal expansion only with the proviso that labor unions would support it by a deliberate policy of wage restraint and with the veiled reservation that the increasing potential for price rises would quickly enough be cut by upward revaluations of the exchange rate. In the absence of such supporting policies one might also find unemployment to increase from cycle to cycle. Rising inflation and ris-

– when excessive real wages have been indexed or when equilibrium nominal wages have been overindexed;
– when supply shocks or labor augmenting innovations bring about a deterioration of labor's terms of trade vis à vis capital or nature and when real wages are inflexible downwards;
– when labor unions raise their degree of monopoly or use their monopoly power;
– when interregional or interindustrial wage differentials are reduced in collective bargaining or when labor monopoly power is used for narrowing wage differentials between skilled and unskilled workers.

ing unemployment produce a positive feedback once high and volatile inflation rates impair productivity growth (as they seem to do in some countries including the U. S.) and once a slowdown in productivity growth (and even a fall in absolute labor productivity) reduces the scope for higher real wages without higher unemployment. The solution described thus means: monetary policy walks up and down the so-called Phillips Curve, but by doing so it shifts the curve in a way that the supposed trade off between unemployment and inflation turns out to be worse from cycle to cycle[3]. There is now considerable evidence that this has been the case in many countries in the seventies. If the combinations of inflation and unemployment rates are shown in a diagram, one does not observe a stable Phillips-Curve but instead Phillips «curls» or «loops» which in some countries (United States, United Kingdom, Canada, France) show a distinct move towards the north-east[4], depicting a tendency for both higher inflation and higher unemployment. A solution under which the central bank is made responsible for both price level stability and full employment must, therefore, also be regarded as inefficient[5].

This leaves us with the third assignment strategy which is medium-term oriented and explicitly acknowledges that an expansionary monetary policy cannot remove classical unemployment except in the short-run. Under this strategy monetary policy is conceived to be price-level policy and the level of employment and capacity utilization in any one area (firm, region, or national economy) is considered to be determined by those who conclude wage contracts binding others (collective wage bargaining with minimum-wage effects) or who fix product prices. This entails a shift of responsibility from governments to markets and from (short-term) demand management to (medium-term) supply policies, including policies to maintain and strenghten competition and the flexibility of relative prices and wages[6].

[3] See *Milton Friedman*, Nobel Lecture: Inflation and Unemployment, in: The Journal of Political Economy, Vol. 85 (1977), pp. 451–472.

[4] See e. g. Bank for International Settlements, Fiftieth Annual Report, Basle 1980, p. 23.

[5] When the failure of the central bank's attempt to reach both targets becomes apparent, there is the danger that the government will switch to an authoritarian solution of the assignment problem by introducing controls of wages, prices and exchange rates and other restrictions which impair the functioning of markets.

[6] Responsibility of the central bank for unemployment is in this setting strictly limited to avoiding Keynesian unemployment. The central bank can discharge this part of its duties by announcing and securing a rate of growth of the money supply that would allow (not bring about) full employment. Moreover, it would be helpful if the implications of the money target for a full-employment oriented wage policy are made sufficiently clear to the public – preferably through advice from independent institutions, such as the Economic Council in Germany. Spelling out the wage policy implications has a pedagogic value. It can help labor union leaders to explain to the rank and file what is required for achieving and maintaining full employment in given circumstances. It also seems useful for enlisting public support to an employment-oriented wage policy whereever labor unions care for public opinion. Moreover, pronouncements about current and future equilibrium wages based on the employment situation in certain sectors and regions seem to be essential for a policy of rational expectations insofar as the Rational Expectation Hypothesis implies that the agents have a sufficient knowledge of the functioning of the system of relative prices and wages as an allocative device.
As a final point it may be worth considering whether there should not be a constitutional or legal rule that allows every citizen who feels excluded from active participation in the labor market to challenge the binding nature of minimum wages established by law or by collective bargaining.

The best way by which monetary policy may achieve its goal of medium-term price level stability would be to let the money supply grow at the same rate as potential output plus – eventually – a correction term which accounts for

- an increase in capacity utilization (if there is an initial recession),
- a so-called unavoidable rate of inflation (in the context of a gradualist strategy to fight inflation – an approach which may be appropriate for countries with low inflation rates),
- a change in the velocity of money resulting from
  - money being a luxury good[7],
  - the reduction in expected inflation rates which leads to an increase in the demand for money[8],
  - shifts in international currency preferences[9].

Since December 1974 the Bundesbank has regularly announced a monetary target for the following year. While this is a step towards a solution of the assignment problem as just described it has neither led to the disappearance of business cycles nor has it so far achieved the task of price level stability. One reason for this result is the fact that the Bundesbank has reserved itself some leeway for discretionary action – either by announcing a target-band (as for 1979 and 1980) or by installing an option to deviate from the target. This scope for discretionary action has been the main cause of the present business cycle in Germany: The monetary expansion in 1978 which was far above the target led to the 1979 upswing and a new surge in inflation, while the subsequent sharp restriction of monetary growth rates to levels at the lower end of the announced band contributed to the recession which started in the second quarter of 1980.

III. Independence: From whom?

If one speaks about the independence of a central bank, in most cases one means independence from the domestic government. But there may be (and has been, at least in Germany) another limit to the autonomy of a central bank, namely the dependence from foreign governments or monetary authorities (including international organisations). In the following we shall deal with both of these two aspects.

1. Independence from domestic government

Apart from moral suasion there are mainly three ways by which the domestic government can control the course of monetary policy:

[7] See *Milton Friedman*, The Demand for Money, Some Theoretical and Empirical Results, in: The Journal of Political Economy, Vol. 67 (1959), pp. 427–455.

[8] See *Carlos Rodriguez*, A Simple Keynesian Model of Inflation and Unemployment under Rational Expectations, in: Weltwirtschaftliches Archiv, Vol. 144 (1978), pp. 1–11.

[9] See *Herbert Giersch*, IMF Surveillance over Exchange Rates, in: The New International Monetary System, ed. *Robert A. Mundell* and *Jacques J. Polak*, New York 1977, pp. 53–68.

- direct functional dependence, i. e. the government is authorized to give instructions to the president or the board of the central bank;
- indirect functional dependence through the exchange rate system: the government fixes the external value of its currency in terms of gold or another currency and thereby establishes a target to which monetary policy must be geared;
- personal dependence which results from the right of the government to appoint and to discharge the board members of the central bank.

1875–1914

When the Reichsbank was founded in 1875 the board of the Reichsbank was subordinated to the prime minister (Reichskanzler). Interestingly, the close direct functional dependence went along with a relatively high degree of personal independence as (until 1924) the president and the other board members were appointed for lifetime. More important than the direct functional dependence of the Reichsbank was the indirect functional dependence through the gold standard, which – although working far from perfectly – governed the course of monetary policy in Germany until 1914[10].

1914–1918

The gold standard was abandoned at the outbreak of World War I. The main target of monetary policy was shifted from external stability towards the financing of the war. Although inflation was suppressed, the wholesale price index more than doubled between summer 1914 und autumn 1918. The Reichsbank did not oppose the large monetary expansion; it is remarkable that the President of the Reichsbank even denied a connection between inflation and monetary expansion – in his view the increase in the money supply was only a response to the additional demand for money resulting from a rise in prices and wages, a larger territory and a high propensity to hoard[11].

1918–1922

Whereas other countries like Britain and France had experienced a similar war-time inflation as Germany, the post-war development was quite different. For while the former two countries returned to a more stability-oriented policy, the Reichsbank continued to finance government expenditures on a large scale. This led to a new surge of inflation rates. The index of wholesale prices which by the end of the war had been at 234 rose to 5,430 in March 1922.

1922–1923

The allied countries suspected that the German government was consciously destroying its currency in order to demonstrate its inability to pay the war reparations[12]. They,

[10] See *Knut Borchart*, Währung und Wirtschaft, in: Währung und Wirtschaft in Deutschland 1876–1975, ed. Deutsche Bundesbank, Frankfurt/M. 1976, pp. 3–55.

[11] See *Heinz Haller*, Die Rolle der Staatsfinanzen für den Inflationsprozeß, in: Währung und Wirtschaft in Deutschland 1876–1975, ed. Deutsche Bundesbank, Frankfurt/M. 1976, p. 130.

[12] See *Gert v. Eynern*, Die Unabhängigkeit der Notenbank, Berlin 1957, p. 6.

therefore, urged the German parliament to establish an autonomous status of the German central bank, in order to put the Board of the Reichsbank in a position to pursue a stability-oriented monetary policy against the interest of the German government.

The law establishing the autonomy of the Reichsbank was passed in May 1922. The hopes for a more stability-oriented monetary policy, however, did not materialize. The Reichsbank continued to finance government expenditures through the printing press. Independence had not made a difference. This was mainly due to the attitude of the head of the Reichsbank. The Reichsbank, whose president Havenstein had been in office since 1908, felt committed to put the request of the German government for financial support above the target of monetary stability. Moreover, there was an apparent incapability on the part of the Reichsbank to recognize the fact that monetary expansion was the main reason for the inflation.

The inflation culminated in the hyperinflation of 1923 which led to the breakdown of the financial system and forced the government to reform the monetary system. The successful issue of the Rentenmark in November combined with drastic restrictions on central bank credits to the government and a fixing of the exchange rate against the dollar led to a rapid stabilization (internally and externally) of the German currency. In its actions the government was not supported by the Reichsbank; it even was a reform against the Reichsbank. This has been one of the few cases in history where a government in its fight against inflation was more determined than the central bank[13].

1924–1933

The experience of 1922–1923 had shown that the independence of a central bank was no sufficient condition for a stability-oriented monetary policy. The allied countries, therefore, urged for restrictions on the Reichsbank's policies. These demands found their way into the Bank Act of 1924. While this act preserved the direct functional and personal independence of the Reichsbank from government[14], it strictly limited the volume of Reichsbank credits to government and, thus, removed the main source of the preceeding hyperinflation. Even more important was the return to a de-facto gold standard. From today's point of view it is interesting that some authors regarded this step as a potential source of inflation; *v. Eynern*[15] argued that a massive sale of gold by the United States might lead to a «gold-inflation», which through the guarantee of the Reichsmark to purchase gold at a fixed rate would also spread to Germany.

As we know today, the true problem of the return to the gold standard turned out to be not inflation but deflation. Under the system of fixed exchange rates the depression which originated in the U. S. rapidly spread to other countries including Germany. Both the German government and the Reichsbank pursued a drastic deflation policy to defend the external value of the Reichsmark. The money supply declined, the price level fell sharply – the wholesale price index which was at 137,2 in 1929 dropped to 110,9 in 1931 – and unemployment rose drastically.

[13] See *Otto Pfleiderer*, Betrachtungen zur Stabilitätspolitik, ed. *Herbert Giersch*, Kieler Vorträge, 90, Tübingen 1980.

[14] The president and the other members of the board were appointed by the General Council (Generalrat) in which government representatives had no seat.

[15] See *Gert v. Eynern*, Die Reichsbank, Probleme des deutschen Zentralnoteninstituts in geschichtlicher Darstellung, Jena 1928, p. 114.

In summer 1931 the Reichsbank could no longer support its currency on the exchange markets. In July 1931 the full convertibility of the Reichsmark was abolished. There has been much speculation about the possible economic and political development in Germany if instead of restricting convertibility the German monetary authorities had decided on a devaluation of their currency – as the British authorities did a few months later[16]. However, it should be noted that in those years there was a wide-spread agreement on the priority of the external stability over the internal stability of the Reichsmark, the main reason being the traumatic experience of 1922–33 and the popular belief that a devaluation of the Reichsmark would lead to a new outbreak of inflation[17]. As the hyperinflation in 1922–23 the great depression in Germany cannot be attributed to a lack of independence of the central bank but only to monetary mismanagement.

1933–1945

Under the *Hitler* government which seized power in January 1933 the autonomy of the Reichsbank was abolished in two steps. The Bank Act of October 1933 enabled the government to appoint and to discharge the President of the Reichsbank and the other board members and, thus, removed the personal independence of the Reichsbank. Through the Bank Act of February 1937 the Board of the Reichsbank was directly subordinated to the government. The government used its position to finance a large part of its expenditures through monetary expansion. In a letter of January 7, 1939 the leading members of the Reichsbank protested against the inflationary spending policy of the government[18].

As a result, the President of the Reichsbank, *Schacht*, and three other members of the board were replaced. The Reichsbank was now under the complete control of the government; its predominant task was to provide the financial means for the war. Parallel to the experience of World War I, the monetary expansion ended in a huge post-war inflation, this time repressed by price controls combined with comprehensive rationing.

1948–1973

The currency reform of 1948 replaced the Reichsmark by the D-Mark. The new currency was first issued by the «Bank deutscher Länder» which in 1957 was transformed into the «Deutsche Bundesbank». In 1958 the full convertibility of the German Currency – which had been abolished in 1931 – was restored.

As to the independence from government the German central bank after 1948 was placed into a similar position as in the Bank Act of 1924: direct functional and personal

[16] *Haberler* convincingly argues that the appropriate way of dealing with the great depression would have been a simultaneous devaluation of all currencies against gold (see *Gottfried Haberler*, How Important is Control over International Reserves, in: The New International Monetary System, ed. *Robert A. Mundell* and *Jacques J. Polak*, New York 1977, p. 116).

[17] See for a more detailed discussion *Heinrich Irmler*, Bankenkrise und Vollbeschäftigungspolitik (1931–1936), in: Währung und Wirtschaft in Deutschland 1876–1975, ed. Deutsche Bundesbank, Frankfurt/M. 1976, pp. 305–307.

[18] Excerpts of this letter are reprinted in *Karl-Heinrich Hansmeyer* und *Rolf Caesar*, Kriegswirtschaft und Inflation (1936–1948), in: Währung und Wirtschaft in Deutschland 1876–1975, ed. Deutsche Bundesbank, Frankfurt/M. 1976, pp. 382–383.

independence[19] but an indirect functional dependence through fixed exchange rates. Like in the Weimar Republic the exchange rate system led to a severe conflict between external and internal stability. But whereas the problem of the early 1930's had been imported *deflation*, the problem now took the form of imported *inflation*.

The limits to the autonomy of the Bundesbank which resulted from the exchange-rate system became first visible in 1960 when the Bundesbank was forced to pursue an overly expansionary monetary policy, because the government refused an appreciation of the D-Mark[20]. Only after price increases had accelerated in early 1961 the government reluctantly decided on a 5 per cent revaluation of the D-Mark. In July 1968 the German Economic Council – after having repeatedly favored exchange-rate flexibility or early adjustments of parities – explicitly urged for an appreciation of the D-Mark, a position that was supported by the Bundesbank in Semptember 1968. The government again rejected a revaluation of the Mark which was, thus, postponed until it became unavoidable in autumn 1969. During this phase «the Bundesbank's anti-inflationary monetary policy was thrown completely out of gear»[21].

Soon after the appreciation the conflict between internal and external stability arose again. In the period of January 1970 to March 73 – which included a brief interval of floating (from May to December 1971), the Smithsonian Realignment, the introduction of heavy controls on German capital imports, and a ten percent revaluation of the D-Mark in February 1973 – the Bundesbank's net foreign reserves rose by approximately 60 billion DM. In March 1973 the parity-system finally collapsed. The fetters which the fixed DM/Dollar-rate had put on the independence of the Bundesbank were removed.

It is certainly difficult to give a precise answer to the question what would have happened if there had been no exchange-rate restrictions to the Bundesbank's monetary policy and, thus, greater independence from government. The experience of 1960/61 and 1968/69, however, suggests that at least in these two cases independence would have made a difference. For it is very likely that without the government's refusal to revalue the D-Mark monetary policy had been less expansionary and more conducive to price level stability.

1973 and afterwards

The transition to a floating DM/dollar-exchange rate did not remove all external restrictions to the Bundesbank's monetary policy. The exchange-rate of the D-Mark remained fixed vis-a-vis the other currencies of the European «snake» (which in 1979 was replaced by the European Monetary System). However, mainly because of the dominating position of the D-Mark these restrictions have been – at least so far – much less severe than the restrictions which had resulted from the fixed DM/dollar-rate.

The collapse of the parity system enabled the Bundesbank to concentrate on internal stability. As already noted the Bundesbank regularly announces a money supply target

[19] The direct functional independence is guaranteed in § 12 of the «Gesetz über die Deutsche Bundesbank» (June 26, 1957). The strong personal independence results from the fact that less than 50 percent of the members of the Zentralbankrat are appointed at the suggestion of the Federal Government (the others being suggested by the regional governments) and that the term for which they are appointed is relatively long (normally 8 years).

[20] The policy of the Bundesbank in this period has later been openly described as a «capitulation» (*Otmar Emminger*: The D-Mark in the Conflict between Internal and External Equilibrium, 1948–1975, Essays in International Finance, 122, Princeton (N. J.) 1977, p. 15).

[21] *Emminger*, The D-Mark in Conflict . . ., p. 26.

since December 1974[22]. With the exception of 1979, however, the actual increase of the money supply has deviated from the target.

The main deviation took place in 1978 when the money supply rose by 11.4 per cent instead of the announced 8 per cent. The main reason for this deviation can hardly be seen in the external constraint through fixed exchange rates in the «snake». Although «snake»-interventions contributed to the rise in the money supply, the most important factor for the monetary expansion were the voluntary interventions to stop the decline of the dollar. The sharp increase of the money supply during this period can be regarded as the main cause for the rise of inflation rates in 1979/80 to levels of about 6 per cent. The far-reaching independence which the Bundesbank enjoys since 1973 has, therefore, not prevented serious violations of the aim of price level stability and a loss of credibility concerning the implementation of pre-announced monetary targets. It may be argued, however, that these violations would have been even stronger had monetary policy been controlled by the government. Thus, when the Bundesbank finally returned to a less expansionary monetary policy at the beginning of 1979, the competent government official in the Ministry of Finance openly opposed this step.

Looking back at the German experience since 1948 it can be concluded that the independence of monetary policy from government tends to be favorable to the objective of price level stability. The Bundesbank was in general more concerned about inflation (or was earlier aware of inflationary dangers) than the government. In this respect the party structure of the government hardly made a difference: conflicts about the course of monetary policy in which the Bundesbank favored a less expansionary course arose under the *Adenauer*-government (as in 1960/61), under the great coalition of christian democrats and social democrats (as in 1968/69) and more recently under the government of social democrats and liberals.

2. Independence from Foreign Governments and Monetary Institutions

a) The Experience during the Weimar Republic

The reform of the monetary constitution in Germany after World War I was heavily influenced by the allied countries. The main result of this influence was the independence of the Reichsbank from the German government which was introduced in 1922 and confirmed in the Bank Act of 1924. It is important to note that a direct functional or personal dependence of the German Reichsbank from foreign governments was not established (although there had been plans that pointed into this direction). The foreign control over the Reichsbank's policies was limited to the surveillance over the provisions of the 1924 Bank Act which had been the subject of an international agreement. The surveillance function of foreign governments which was institutionalized in the Bank Act of 1924 was removed by the revision of the Bank Act in 1930. The main achievement, however, which had been due to the foreign influence, i. e., the direct functional and personal independence of the Reichsbank remained until it was finally destroyed by the *Hitler* government.

[22] This target relates to the monetary base as defined by the Bundesbank («Zentralbankgeldmenge»); it shows a similar behaviour as M 3.

b) The Experience after World War II

When the Federal Republic of Germany joined the International Monetary Fund the German Central Bank faced – apart from moral suasion – three potential sources of dependence of the IMF. First, the IMF was entitled to combine balance-of-payments credits with specific demands in respect to the course of monetary policy. This aspect – which has been important for some countries – did not play a role for Germany which turned out to be a country with a very strong currency. Secondly, the IMF might have opposed a revaluation of the D-Mark. Again, this aspect has not played a role. The resistance against the appreciation of the D-Mark – which proved harmful for a stable monetary policy in several periods – was not of international origin but came from the domestic government. Third, the credit facilities of the IMF (and the more recently created facilities of the EMS) enable foreign governments or monetary institutions to induce an expansion of the money supply in Germany. The use of these credit facilities played a substantial role, although until now it cannot be made responsible for an overly expansionary policy, since the Bundesbank has the means to neutralize the resulting change in its money supply by other measures. The main importance of these credits lies in their effect on the international distribution of seigniorage gains. Since these credits are given at interest rates below the market rate, the borrowing institutions benefit whereas the Bundesbank (and in the end the German taxpayers) faces a corresponding loss in income.

IV. Conclusion

Independence of a central bank from government interferences is no guarantee against monetary mismanagement as evidenced, e. g., by the hyperinflation of 1922/23 which occured at a time when the German Reichsbank enjoyed a status of almost complete independence.

The post-war experience in Germany, however, suggests that the independence of the Bundesbank from government directives tended to be conducive to price level stability in the Federal Republic as the Bundesbank was generally more concerned about inflation (or earlier aware of inflationary dangers) than the government.

Nevertheless, one has to take account of the fact, that since the collapse of the parity system in 1973 and the resulting far-reaching functional independence of the Bundesbank, monetary management was still far from perfect. Apart from the consideration that the Bundesbank's choice of denominating its monetary target in terms of central bank money may be regarded as inferior compared to a target for M1, the major mistake was the fact that the Bundesbank exceeded its monetary target for 1978 by a substantial amount – a mistake which was later openly admitted by the President of the Bundesbank[23]. It should be noted, however, that the main reason for the deviation from the monetary target was not an attempt by the Bundesbank to pursue a Keynesian employment policy. The main reason rather was that the Bundesbank thought to observe an unforeseen increase in the demand for German currency indicated, inter alia, by the

[23] See *Otmar Emminger,* Konjunktur, Geldpolitik, Geldwertstabilität: Ausführungen auf der Jahrestagung des Bundesverbandes der Deutschen Industrie, Bonn, 12. Juni 1979, in: Deutsche Bundesbank, Auszüge aus Presseartikeln, 1979, Nr. 40, vom 15. Juni 1979.

substantial real revaluation of the D-Mark against the Dollar. While it cannot be excluded that such a change in preferences actually took place in 1978 as a result of changes in international currency preferences, it is apparent that the Bundesbank overestimated the size of this factor. Moreover, empirical investigations for West Germany reject the thesis that real exchange-rate changes are a sufficiently reliable indicator for autonomous changes in the demand for money[24].

This observation suggests that because of the lack of reliable indicators for changes in the demand for money deviations from monetary targets in a medium-size country like Germany may easily be counterproductive for the objective of monetary stability and that central banks in such countries may be well advised to forgo the scope for discretionary action which so far they have reserved for themselves.

Summary

The paper discusses the independence of monetary policy under two aspects. The first aspect concerns the question: towards which target should an independent central bank gear its policy? It is argued that for monetary policy price level stability is a better target than full employment. Moreover, it is shown that the adjustable peg system of Bretton Woods prevented a rational solution to the assignment problem in the Federal Republic of Germany. The second aspect relates to the different forms of dependence which a central bank may face. A historical survey for Germany, stretching back until 1875, provides evidence for the thesis that independence of a central bank is no guarantee against monetary mismanagement; the hyperinflation of 1922/23, e.g., took place at a time when the German Reichsbank enjoyed a status of almost complete independence. Recent experience, however, also suggests that independence of the Bundesbank from government directives has tended to be conducive to price level stability in the Federal Republic as the Bundesbank was in general more concerned about inflation (or earlier aware of inflationary dangers) than the government.

[24] See *Enno Langfeldt* and *Harmen Lehment*, Welche Bedeutung haben «Sonderfaktoren» für die Erklärung der Geldnachfrage in der Bundesrepublik Deutschland?, in: Weltwirtschaftliches Archiv, Vol. 116, No. 4 (December 1980).