OTMAR ISSING
AN ECONOMIST AND ARCHITECT OF SUPRANATIONAL INSTITUTIONS

by Guido Montani

Otmar Issing’s career is a clear example of how an economist, thanks to his solid theoretical background, may be called to hold positions of great responsibility, first at the Bundesbank and then at the European Central Bank (ECB) where, according to Jean-Claude Trichet, “He has played a crucial role in the success of the transition to the Euro and in enhancing the credibility of the monetary policy of the ECB … The ECB and the Eurosystem owe him an immense debt of gratitude”.

Professor Issing began his career at the University of Würzburg where he wrote a few successful textbooks on monetary economics like Enführung in die Geldtheorie and Einführung in die Geldpolitik, and where he taught his students that the essential task of monetary policy is to ensure price stability as this would generate a high level of trust in financial institutions among the general public. This doctrine is not based on abstract theoretical models but has its roots in Germany’s tragic historical past. “I am old enough – wrote Issing – to remember such a period in post-war Germany, before the currency reform of 1948”\(^1\). His nomination, in 1990, to the Bundesbank Board could have been considered the highpoint of his career if not for the fact that, at the same time, the idea of a European Monetary Union (EMU) had begun to gather pace. However, despite his undeniable scientific merits, when the German government proposed him as a member of the Euro-

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pean Central Bank Executive Board in 1998, many critics opposed his nomination. Issing himself explained the reasons for this, candidly admitting that “I was held to be an economist who was at any rate sceptical about the 1st January 1999 as a starting date for the Monetary Union, if not allegedly about the whole euro project”\(^2\). Despite these dissenting voices, the German government proceeded with his nomination.

So it happened that a Euro-sceptic became one of the main architects of the European single currency. Creating from nothing a supranational central bank was not an easy task and Issing, as the Head of the Directorates General for Economics and Research, could not yet rely upon the full support of his economist colleagues. Milton Friedman, on that occasion, wrote Issing a letter of congratulations for his nomination to an “impossible job”. Friedman predicted that EMU would collapse within five years. Issing was conscious of the challenge that lay ahead. He could not rely on his past experience, not even that accumulated at the Bundesbank. “The start of the European Monetary Union presented a challenge several orders of magnitude greater. It is difficult to overstate the uniqueness of this event, one without historical parallel. ‘Sailing into unchartered waters’ is how the challenge facing the ECB was commonly characterised … Robert Lucas highlighted the serious potential effect of such a *regime shift* … If policy ignores the influence of the *regime shift* and continues to rely on existing model parameters, mistakes will inevitably result”\(^3\).

Issing however was not discouraged. With the help of his collaborators, he exploited every last second available before the fateful 1st January 1999 deadline when the exchange rates between European currencies would be definitively fixed and the Euro would become the supranational currency. There are two important results that emerge from this preparatory phase that should be recalled. The first is the monthly publication, from January 1999 on, of the ECB *Monthly Bulletin*. Its publication was essential for affirming the credibility and transparency of the new central bank monetary policy. “By a huge effort – recalls Issing – we managed to prepare and publish the *Monthly Bulletin* for January 1999. Before long, the *Monthly Bulletin* would gain worldwide recognition as the ECB communication ‘flagship’”\(^4\).

\(^3\) O. ISSING, *The Birth of the Euro*, cit., pp. 78-79.
The second, more demanding, task was setting the guidelines of the ECB monetary strategy. This called for an immense intellectual effort on the part of Issing and his team of collaborators. They took into consideration all existing proposals from the academic world and from central bank practices before formulating a solid European approach. Finally, on 13 October 1998, the ECB Governing Council announced to the press that its monetary policy would be founded on the pursuit of the fundamental target of price stability, by means of what later become known as the “two pillars strategy”. The primary pillar – a monetary pillar – was “price stability”, whereby the ECB meant: “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 per cent.” The second pillar – an economic pillar – was broader in scope and consisted in “a wide range of economic and financial variables as indicators for future price developments”.

When Issing left the ECB in May 2006, he could take satisfaction from seeing that the Euro had established its position as the world’s second currency, alongside the dollar, but with a reputation of higher stability. This was an undoubted success. In a paper, dedicated to Otmar Issing’s work at the ECB, some economists drew attention to how “Charles Goodhart formulated his famous law ‘that any observed statistical regularity will tend to collapse once pressure is put upon it for control purposes.’ Issing examined Goodhart’s law and interpreted it as a particular case of the Lucas critique. Goodhart’s law was inspired by the historical example of change and instability of monetary policy in the UK. Thus, Issing, inspired by his experience of the Bundesbank, decided to spin the Lucas critique in the opposite direction. Our favourite formulation of Issing’s law is: ‘a policy … geared to steadiness and medium-term objectives reinforces … stability … and hence the foundation of the policy itself.’ Goodhart’s law stresses a vicious circle of instability generating instability. Issing’s law, instead, stresses the virtuous circle of stability begetting stability. Thus one of our major conclusions is that the success of the ECB illustrates the practical relevance of Issing’s law”.

This recognition of the importance of the ‘Issing Law’ should be shared. However, this did not exhaust Issing’s intellectual endeavour. “The birth of the euro – observed Issing rightly – is a unique event. Never before had sovereign States ceded their responsibility for monetary policy to a supranational institution”6. Issing’s contribution also extended to his tracing a route for navigating through those “uncharted waters” represented by supranational institutions. From his perspective, Issing was able to criticise some theoretical positions that were, and still are today, rooted in economic thought. Many economists, from the Chicago School onwards, argue that monetary policy should be conducted according to fixed rules, in order to be subtracted from the arbitrary discretion of national governments. To avoid the negative effects of this practice, at a constitutional level, a quantitative limit to the yearly creation of money should be established7. Issing considers both Friedman’s theses and an even more radical anti-statist approach. In the seventies, with the creation of the European Monetary Union likely, Friedrich Hayek called for the abolition of the national governments’ monopolistic control over money, in the belief that the market, thanks to the competition between commercial banks, could more efficiently manage the task of supplying money to the public. The aim was the denationalisation of money. In Hayek’s opinion, this proposal “would indeed seem to satisfy all the requirements of a common market better than a common currency without the need to establish a new international agency or to confer new powers on a supra-national authority”8. By entrusting banks with the task of issuing money, Hayek wished to cut off at the roots governments’ power to fall back on monetary policy: if it is the market that supplies money to the public, the macro-economic notions of money supply and demand become superfluous. It was a proposal that would revolutionise not only national economies but also the international system of payments; if adopted, today neither national currency areas nor fixed or flexible exchange rates would exist9.

Issing observes that Hayek ignored a decisive function of money: “His recommendation neglected the ‘public good’ aspect of money,

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9 F. HAYEK, *Denationalisation of Money*, cit., p. 86.
which derives from its function as a unit of account. Money with a stable purchasing power serves as the universally acceptable unit of account even for agents who do not use it as a medium of exchange or store of value.”

Indeed, the creation of the European monetary union and of the Euro has raised many benefits for European citizens in terms of welfare gains, the elimination of foreign exchange transaction costs and new competitive opportunities for the banking and financial industries. More generally, to tackle the crucial problem posed by Friedman and Hayek, it can be affirmed the EMU renders the ECB truly independent from political powers “and enables it to pursue its mandated ultimate objective, that is price stability, without interference from governments. Thus monetary policy in the Euro countries has been denationalised and is being conducted by a supranational central bank, which is politically independent of the governments of the Member States. Furthermore, any monetary financing of the public sector or privileged access to financial institutions is prohibited. The separation between fiscal and monetary policy is thereby ensured.” This claim is a critique not only of Hayek’s claim to put an end to “the unholy marriage between monetary and fiscal policy”, through a theoretical currency competition, but is also a response to Friedman’s desire to impose rigid, constitutional limits to money issuance.

These hints at the independence and statutory aims of the ECB lead to a second theoretical contribution by Issing which should be underlined: the value of institutions, the rule of law in relation to the rule of men. Issing states very clearly that the task of central banks, though based on solid statutory foundations, as in the ECB case, cannot be limited to a mechanical fulfilling of their tasks. “Theory and practice – believes Issing – have confirmed the importance of an appropriate institutional framework for the central bank based on independence and clear focus on price stability, supplemented by a sound monetary policy strategy. … It must however be recognised that the ‘stability culture’ of society also matters … The central bank has to play a leading role in its communication with the public and in enhancing the degree of economic literacy”.

Thus, one of the tasks of monetary institutions

11 O. Issing, Hayek, Currency Competition and European Monetary Union, cit., p. 31.
is to educate the public towards a culture of monetary stability through the adoption of a clear monetary strategy and an efficient communication. “Institutions, such as central banks themselves – argues Issing – represent sets of rules. They are a way of reducing reliance on faith in the wisdom and moral virtue of individuals in the pursuit of desirable objectives. Institutions delineate the power of individuals and limit their discretion in the exercise of power.”\(^\text{13}\). This means that the individuals responsible for running public institutions are not totally free to choose a particular policy but, at the same time, neither are they completely tied a mechanical line of conduct. There is room for manoeuvre within which wisdom matters, because, despite the best available models and techniques, unexpected situations may arise and have to be faced. A central bank should also be able to carry out the difficult role of lender of last resort, especially when crises are big enough to put the entire financial and economic system in danger. The recent financial crisis demonstrated very clearly that it was not possible for the ECB or the US Federal Reserve to follow rigid rules drawn from past experiences when acting as a lenders of last resort.

The current financial crisis forces Europe to navigate in “uncharted waters”. Indeed, the EMU is facing today an existential crisis that, in some way, Issing predicted a few years ago when he underlined a crucial problem specific to the Euro: it is a currency without a State. Issing saw clearly that the Euro is a currency common to many States but that the problem of a common fiscal policy has yet to be resolved: “the area where the currency and politics rub up against each other is that of public finance.”\(^\text{14}\). Recent tension between governments in EMU about how best to manage the public debt crisis in Greece shows up areas where the European project is lacking. The Stability and Growth Pact (SGP) has not been able to solve the problems of fiscal discipline between Euro countries. Here two opposing theories collide: on the one side are supporters of the maintenance of the rules in place when each country joined the EMU and the SGP; on the other are those claiming that the European Union is more than a monetary union; the Union should tackle the growth and development needs of all countries in the new context of a global market\(^\text{15}\). To face this challenge, the Eu-

\(^{13}\) O. ISSING, *Should we Have Faith in Central Bank?*, cit., pp. 28-29.


\(^{15}\) J. DELORS, *I could be more critical of the Lisbon Treaty*, interview in “Euractiv”, 3
European Commission, backed by the European Parliament, has recently proposed to issue “EU project bonds” to finance infrastructure, in areas like energy, transport and ICT and to finance the EU budget with own real resources. Issing fears that this proposal might produce negative effects, because “a common bond, by virtue of its construction, would delete the interest rate spread between bonds issued by different Euro area countries.” The debate on this issue is open. It is certainly true that a monetary Union, in itself, is not a State and that the fiscal power cannot be exercised without a corresponding democratic control power. Issing claims that: “Western democracy is rooted in the control of public revenues and expenditures by Parliament. Governments are accountable to their National Parliaments and ultimately to their voters ‘at home’. Were tax and fiscal policy as a whole to be made a European cause, there would indeed have to be a European statehood, a European government, and legitimacy conferred by Parliament elected on established democratic criteria (one person, one vote).” And it is true that the European Union, at the moment, does not satisfy all this democratic criteria.

It is not only the future construction of Europe that is under discussion. The financial crisis of 2007-2009 is provoking a profound revision of economic theory and practice. Economists from various theoretical backgrounds are sharpening their swords. Otmar Issing did not draw back from the fight. Heading a group of economists, he wrote in view of the G20 meeting in London (in April 2009) a report for a “New Financial Order” in which he suggests an increase in the transparency of finance through the use of a global risk map complemented by a credit register, which together would use statistics reported by banks to monitor the level of risk in the financial system. Together with these tools aimed at limiting financial risk, new roles for central banks should also be envisaged. The de Larosière Report on financial supervision in the EU “proposes the creation of a European Systemic Risk Board (ESRB) with the ECB in the leading role.” This proposal,
backed by Issing, is going to be adopted by European institutions. According to Issing, ratings agencies should also be monitored because they “have played a harmful role, accelerating and widening the crisis … they have to be supervised by a public authority and their rating performance must be made more transparent in order to foster competition among ratings agencies”20. Lastly, even central banks strategies ought to be reviewed in order to take into account the possible effect of financial bubbles. Until now, central banks have adopted certain guidelines suggesting that they should not intervene until a financial bubble bursts, but “central banks should follow a ‘mop up’ strategy after the burst of the bubble”21. However, this strategy has proved extremely costly for public finances. Furthermore, “restricting the role of central banks to a totally passive task in the period of the build up of a bubble and practically pre-announcing its role as the ‘savior’ once the bubble bursts represents an asymmetrical approach that risks creating more hazard with actors driving the development of asset prices”22. Consequently, Issing’s proposal is that the central banks strategy, while maintaining the goal of stabilising consumer prices (even though the index does not include the cost of financial activities), should also watch out for signs of the development of financial bubbles. More attention paid to the value of financial activities means an extension of the strategic horizon. “The widening of the time horizon for the conduct of monetary policy – this is Issing’s conclusion – functions as a kind of ‘integrated risk management’ that works symmetrically in both directions: leaning against the ‘headwind’ (asset price declines) as well as against the ‘tail wind’ (increases). This approach is in contrast to the mop up strategy”23.

These recent reflections confirm Otmar Issing’s constant tracking of institutional issues, especially those faced by supranational institutions. The European Union, despite its evident gaps, is an experiment that is at the forefront of an ever more interdependent world, on the lookout for rules and institutions that will permit the peaceful governance of a global community. Jean Monnet, one of the founding fathers

22 O. ISSING, Asset Prices and Monetary Policy, cit., p. 46.
23 O. ISSING, Asset Prices and Monetary Policy, cit. p. 50.
of a united Europe, recalls that “the life of institutions is longer than that of man’s and thus institutions can, if constructed soundly, accumulate and pass on wisdom to successive generations”. Otmar Issing, as the first chief economist at the ECB, has certainly contributed, wisely, to construct and strengthen an institution that has allowed Europeans to benefit from a stable currency and make Europe a global player on the world political scene. Future generations can follow the route traced by Otmar Issing with confidence, even though the exploration of the uncharted waters where supranational institutions navigate is far from over. For this, the Faculty of Economics of the University of Pavia is proud to confer Professor Otmar Issing an Honorary Laurea Magistralis degree in International Economic Integration.

Riassunto – Discorso tenuto il 22 novembre 2010, presso la Facoltà di Economia dell’Università di Pavia, in occasione dell’attribuzione della Laurea Honoris Causa in Integrazione Economica Internazionale al prof. Otmar Issing. La sua carriera – afferma Montani – rappresenta il limpido esempio di un economistà che, grazie alle sue solide convinzioni teoriche, è stato chiamato a occupare posizioni di grande responsabilità, prima nella Bundesbank e poi nella Banca Centrale Europea, dove – secondo Jean-Claude Trichet – “è stato un attore eccezionale e decisivo nella costruzione dell’euro”. Come capo del Dipartimento per l’Economia e la Ricerca presso la BCE, gettò le basi organizzative ed editoriali per il Bollettino mensile della BCE; elaborò inoltre le linee fondamentali della strategia della BCE, oggi nota come strategia dei “due pilastri”: quello monetario e quello economico. Quando, nel maggio 2006, Issing lasciò la BCE poteva osservare con orgoglio che l’euro si era ormai affermato come la seconda moneta mondiale, alle spalle del dollaro, ma con una maggiore reputazione di stabilità. Il prof. Issing, oltre ad aver teorizzato il ruolo delle istituzioni economiche per la stabilità e lo sviluppo economico, ha anche mostrato di essere un saggio architetto nella costruzione dell’UEM.
Magnifico Rettore, Dear colleagues, Ladies and gentlemen,

È per me fonte di grandissimo onore ricevere la Laurea “Honoris causa” della Facoltà di Economia dell’Università di Pavia. Avendo speso la mia intera carriera professionale a costruire “Ponti” tra studi accademici e politica economica, ricevere questo titolo suscita in me orgoglio, ma anche grande modestia.

To receive this award from one of the oldest and most prestigious universities in Europe is an honour for which I hardly qualify. The University of my hometown was founded in 1402. However, while Pavia attracted famous academics the University of Würzburg was closed not very long after its start when a student killed the Rector. It was refounded in 1582 and since then students have become much more civilized.

I am deeply moved and would like from the bottom of my heart to extend my gratitude to the University of Pavia and the Faculty of Economics. Personally I thank the Magnifico Rettore Professor Angiolino Stella, the Preside Professor Carluccio Bianchi, and Professor Guido Montani for his more than generous Laudatio.

Coming today to Pavia from Germany I could exploit an achievement which in its old form dates back to the time of the Roman Empire. It is not that a Roman merchant could travel by train and plane – but on his long trip from Rome to e.g. Colonia Claudia Ara Agrippinensium (today’s Cologne) he was able to pay using the same coin, the denarius. After two millennia, full with chaos and wars, 16 European countries are united by a common currency, the euro. This is an out-
standing success – unique in the history of mankind. Never before have sovereign states transferred the competence in such an important field as the currency to a supranational institution, the European Central Bank. I had the privilege to become a member of its Executive Board for the first eight years of its existence being responsible for economics and research. This was the heyday of my professional life.

In this moment my memory goes back to the time when this great experiment started: On 7 May 1998 at the Hearing before the European Parliament preceding my appointment I explained: “Someone born in 1936 like me, who walked to school through the rubble of his completely flattened hometown, would later be able to see European borders open up, and take freedom to travel – at least in Western Europe – for granted. He would be able to experience the wealth of European culture at its original sites, and I want to add: Italy being an outstanding case, and to make friends in countries where according to his schoolbooks the enemy lived.

This experience shaped my sense of history. Thus it was in fact quite logical that, when studying economics, I very soon turned to questions of European integration. The dismantling of all trade barriers, the free movement of persons – in short, the four great economic freedoms – were the grand objective that was achieved with the single market. I will not deny that I was more hesitant with regard to monetary union – not as regards the grand goal, which was always the culmination, the completion of integration, but rather out of concern about the great leap. Concern because I know, or think I know, what monetary union means, what its consequences are for many economic and political spheres beyond the monetary one.

The introduction of the euro will change the face of Europe. The introduction of the euro is the most significant event in the world of international money and finance since the end of the Second World War. The euro will only be able to play its intended role if it is a stable currency.

And finally: A currency lives by the trust of the population in monetary stability!”

No doubt, the euro has become a stable currency shared now by 330 Million people. It is the second most important currency in the world and enjoys the confidence of investors on a global scale. Inflation expectations are well anchored. This success is in stark contrast to the opinion of so many sceptics: Back in 1998 a few weeks after being in office I received a letter from the late nobel laureate Milton Fried-
man saying: “Dear Otmar – Congratulation on an impossible job. I am convinced European Monetary Union cannot work, it is doomed to fail.”

And now, with all the daily alarming news are Friedman and others finally proven right? My short answer is: no. However, nobody would deny that after almost twelve years the euro area is in a deep crisis. This crisis did not come as a surprise. EMU is based on two pillars. One is the ECB with its independence and a clear mandate for maintaining price stability. The other is solid public finances. To guarantee this fundament the Stability and Growth Pact was ratified. However, the rules of the Pact were neglected time and again.

Huge divergences in competitiveness and macroeconomic imbalances have also contributed to the emergence of the crisis. Years ago in my book on the “Birth of the Euro” I chose the title “Europe at the Crossroads” for the last chapter. Today, I am deeply concerned. The future of EMU now crucially depends on how we deal with the situation.

Every crisis also offers a chance. In Greece, for example, the realization that the country stood on the edge of the abyss is opening the way to reforms that would have been unthinkable just a short time ago. The crisis of monetary union, which came anything but unexpected, exposes the weaknesses of the existing arrangements and thus offers an opportunity to make substantive improvements to the regulatory framework. As things stand, there is reason to fear that this opportunity will be seized at best marginally, and essentially wasted.

However, a look back at the past might offer reassurance. After all, “Europe”, to use this term, has been through many crises and all in all has emerged stronger from each one. There is, it is true, no guarantee that this method will continue, even if there is no reason to see only doom and gloom ahead. However, the character of the crises changes with each incremental change to the EU’s institutional framework. The EMU member countries may again shy away from a significant strengthening of the rules. But in light of the experience of almost twelve years of monetary union, this makes the eruption of a new crisis in the not too distant future inevitable. Perhaps, under possibly even greater pressure, the EMU will then be willing to undertake fundamental reforms? In the meantime, what under current circumstances seems to be an unstoppable course towards further fiscal transfers will create economic and above all political tensions on a scale that will pose all the bigger a threat to the survival of EMU, in case countries will not continue with reforms and the future would be characterized again by
unsound policy behavior on the part of individual member states. So one might also say: the hour of truth has only been deferred.

Monetary union is, so to speak, the centre of gravity, the focal point of the process of European integration. To that extent, it also means that the whole EU is not unaffected by the turbulences within EMU. Without a stable euro, the other countries also lose their anchor. One can of course speculate at will about the future of the EU. What degree of political integration will the community of 27 (plus new members) aim for? Will new groupings emerge and agree on closer cooperation? What will be their relationship with the members of EMU?

Past models are not suited as a blueprint for the process of European integration. Europe has discovered new forms of integration in the past, and will continue to do so in future. The overriding concern is the preservation of peace. Beyond all honorable political intentions, there is one thing that needs to be borne in mind: the economy and the currency are by no means everything, and ultimately not even the most important thing. But, without economic success and stability, even the status quo would be at risk, and a fortiori the prospects for the future would look anything but promising. This is true both for Europe in isolation, as it were, and all the more so in a world where globalization continually poses new challenges.

The success of European integration hinges first and foremost on increasing prosperity. While the original objective of European integration was clearly political in nature, under the force of circumstances a small but growing group of countries embarked on the path of integration of national economies. It is largely to this economic success that “Europe” owes its attractiveness. Accordingly, all projects aimed at deepening political integration need also to be measured in terms of their contribution to economic success.

Both politically and economically, European integration is an unparalleled success story. All our efforts must be directed towards seeing the crisis as an opportunity, and, rather than jeopardising its continuation through ill-conceived crisis management measures, towards underpinning it with a solid foundation based on democratic legitimacy. In the end, one needs constantly to recall just how much today Europe differs from that of the twentieth century, especially its first half. The more remote the year 1945 becomes, the more the memory of war and destruction and Europe’s subsequent resurgence risks being lost.

Ladies and gentlemen, allow me to conclude with reference to a moment which highlights the essence of European integration since the
end of World War II: In the ECB’s first year, I happened to be sitting at lunch one day with the then Vice-President Christian Noyer for company. Swapping personal experiences, we discovered that his father, a French soldier, had been interned in a German prisoner-of-war camp at the same time as my own father was in France with the German occupying forces. A bit more than fifty years later, the sons of these two combatants were working together at the ECB to help make the euro, the common currency, a success, and not just in France and Germany.

**Riassunto** – Il prof. Issing, dopo aver ringraziato le autorità accademiche per il riconoscimento della Laurea Honoris Causa, ricorda brevemente la sua audizione al Parlamento Europeo, avvenuta prima di assumere l’incarico come membro del Board della BCE. In quell’occasione, Issing ribadisce la sua convinzione della necessità che la Banca centrale persegua una politica di stabilità monetaria, nell’interesse dei cittadini europei. Per quanto riguarda il futuro dell’UEM, Issing si dichiara fiducioso che le attuali turbolenze vengano superate: esse riguardano più l’aspetto delle finanze pubbliche che non le fondamenta monetarie dell’UEM. Conclude il suo intervento ricordando che nella BCE ha incontrato il suo collega francese Noyer, il cui padre era internato in Germania durante la seconda Guerra mondiale mentre il padre di Issing si trovava in Francia tra le truppe di occupazione. I due figli oggi si sono trovati a lavorare insieme per la moneta comune: questo è il senso storico e politico dell’unificazione europea.