EP302.tex

How Should the Eurosystem Reform Its Monetary Strategy?*

Lars E.O. Svensson
Princeton University, CEPR and NBER
Homepage: www.princeton.edu/∼svensson

February 2003

Abstract

The Eurosystem should modify its definition of price stability to a symmetric and unambiguous inflation target, at the level of 1.5 or 2% per year. It should abandon its two-pillar strategy and adopt the superior international-best-practice strategy of flexible inflation targeting. The big question is whether the Eurosystem will be able to abandon its stubborn defense of an inferior monetary-policy strategy and seek a genuine improvement of its strategy.

At the ECB's press conference on December 5, 2002, ECB President Willem Duisenberg received a question on whether the Governing Council saw any reasons for changing anything in the future in its two-pillar monetary-policy strategy. The much noted, and quite surprising, answer was: "We are aware of the comments made here and there and now and then about our two-pillar strategy. We have decided, in the course of next year, to come up with a serious evaluation, not necessarily a change, because we are still happy with our strategy. But we will make a serious assessment and evaluation of the monetary strategy in the course of, I think, the first half of next year." (ECB [4]). This answer was a welcome alternative to the Eurosystem's usual stubborn official defense of its strategy. It was also a welcome indication of a possible reconsideration and change in the Eurosystem's strategy.

As every observer knows, the Eurosystem's monetary-policy strategy has serious flaws. These flaws have been extensively discussed, for instance, in many reports by the several Eurosystem watcher groups. I have discussed these flaws in several academic articles, for instance, Svensson [13], and in previous briefing papers to the European Parliament's Committee on Economic and Monetary Affairs, for instance, Svensson [14]-[17] and [19]-[21]. Duisenberg's answer again raises

*Briefing paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament for the quarterly dialogue with the President of the European Central Bank. I thank Kathleen DeGennaro for editorial and secretarial assistance. Expressed views and any errors are solely my own responsibility.

two questions: (1) How *should* the Eurosystem reform its strategy? (2) *Will* the Eurosystem actually reform its strategy?

The Eurosystem strategy consists of a "definition of price stability" and "two pillars." Both the definition of price stability and the two pillars need to be reformed.

1. The definition of price stability: Adopt a symmetric inflation target of 1.5 or 2%

The Eurosystem's definition of price stability is "an increase in harmonised consumer prices of below 2% [per year]." As discussed in Svensson [20] and in some more detail in Svensson [17], the definition of price stability is problematic, because it is ambiguous and asymmetric, and therefore less effective as an anchor for inflation expectations. The definition is *ambiguous* because it is *unclear* about the lower bound of the inflation range.[1] The definition is *asymmetric* because the upper and lower bounds are announced with *different precision*; the upper bound is precise whereas the lower bound is imprecise.[2]

How should the Eurosystem improve its definition of price stability? An unambiguous and symmetric definition would be a point target, "an increase in harmonised consumer prices of x%," or a target range, "an increase in harmonised consumer prices of between x and y%."

One alternative is a target range with $x = 1$ and $y = 2$, 1–2%. As discussed in Svensson [20], a speech by Issing [8] in June 2002 can be interpreted as suggesting that alternative. I believe 1–2% would be a significant improvement over the current definition. First, 1–2% is unambiguous and symmetric. Second, 1–2% is such a narrow interval that it is clear that inflation, because of imperfect control and unavoidable shocks, will sometimes be above 2% and sometimes below 1%. Thus, this is a sensible soft-edged rather than hard-edged interval (see, for instance, Svensson [18] for a discussion of hard-edged versus soft-edged target ranges). It is indeed equivalent to a point inflation target of 1.5%, with the understanding that this is a target to aim for *ex ante,* but that inflation *ex post* will normally deviate from the target. Hence, the target can only be met as an average over several years. Third, there is a certain continuity in 1–2%, since a 1.5% point inflation target is what the Eurosystem seems to use when calculating its reference value for the unfortunate first pillar (see Svensson [13] for details of the calculation). Indeed, the Eurosystem is probably best interpreted as currently having effectively a point inflation target

[1] About a month after the definition was announced on October 13, 1998 (European Central Bank [3]), Duisenberg [2], in a speech on November 10, clarified that the word "increase" should be interpreted as excluding deflation. The precise lower bound has since then been left unspecified, with occasional reference to uncertain measurement bias between measured and true inflation. In Issing's [8] words, the Eurosystem has been "maintaining flexibility as to the lower bound."

[2] If uncertain measurement bias were the reason for the ambiguity, logic would seem to imply that both the lower and the upper bound would be equally affected.

of 1.5% (that is, "below 2%" actually means "half a percentage point below 2%"), so the 1–2% would completely consistent with this.[3]

A second alternative is to raise the inflation target somewhat, for instance, from (effectively) 1.5 to 2%. This can be done with either a point target of 2%, a narrow range of 1.5–2.5%, or a wider range of 1–3%. The main reason for such an increase would be to have a somewhat larger "cushion" (in Meyer's [10] words) to zero inflation and to deflation. This reduces the risk of interest-rate setting being restricted by the zero lower bound for interest rates and the risk of the euro area ever falling into a deflationary spiral. It could also reduce the plight of parts of the euro area (read Germany) temporarily suffering from too low inflation together with possible downward nominal wage rigidity.[4] A 2% inflation target would give the Eurosystem the same target level as Bank of Canada, the Reserve Bank of New Zealand (after the increase of its target from effectively 1.5 to 2% in the new Policy Targets Agreement of December 2002, Reserve Bank of New Zealand [12]) and Sweden's Riksbank.

A third alternative is to raise the inflation target to 2.5%, to the same level as that of the Bank of England, the Reserve Bank of Australia, Norway and Iceland. This would give an even larger cushion to zero inflation.

I believe that the most important reform is to introduce a symmetric and unambiguous inflation target, and that this is more important than the precise level of the target, as long as the target is not lower than 1.5% or higher than 2.5%. Concerning the level of the target, a rise of one percentage point from the current 1.5 to the new 2.5% might be interpreted by many as a weakening of the commitment to price stability. From this point of view, an unchanged level of 1.5% or a small rise to 2% might be preferable. Concern about downward nominal rigidity would favor 2% before 1.5%. On balance, 2% (in the form of a point target of 2% or target ranges of 1.5–2.5% or 1–3%) may be the best choice for the Eurosystem, but a symmetric inflation target of 1.5% (in the form of a point target of 1.5% or target ranges of 1–2% or even 0.5–2.5%) would also be an improvement.

[3] Goodfriend [7] proposes an inflation target for the U.S. of 1–2% in terms of the core Personal Consumption Expenditure (PCE) price index, and points out that core PCE inflation for the U.S. has fallen in that range since the 1990s. Ben Bernanke, at his confirmation hearings at the U.S. Senate in August 2002, also suggested an inflation target for the U.S. of 1–2% core PCE (New York Times [11]). The FOMC transcripts from July 1996, [6], could be interpreted as FOMC members more or less agreeing on an interim inflation target of 2% for the core CPI (at the time core CPI inflation was a bit below 3%). Becasue of differences in the construction of the indexes, core CPE inflation for the U.S. may fall below core CPI inflation by 0.5–1 percentage point (see the chart "Price Inflation Excluding Food and Energy" in Federal Reserve Bank of San Francisco [5]).

[4] However, if the euro area would fall into a liquidity trap and deflationary spiral, my proposed "Foolproof Way" to escape from a liquidity trap and deflation, could be used. I argue in Svensson [22] that it is likely to work for the euro area and the U.S. at least as well as for Japan, for which country it was originally designed. A recent paper by Coenen and Wieland [1] present interesting simulations in a three-region model of Japan, the euro area and the U.S. of three different ways of escaping from a liquidity trap in Japan suggested by Orphanides and Wieland, McCallum, and me. There is no reason why, in their model, these ways would not work equally well for the euro area and the U.S.

2. The two pillars: Incorporate the first pillar into the second, and adopt flexible inflation targeting

Regarding the two pillars, as has been said over and over again, the only sensible choice is a *one pillar* strategy, where all relevant information (including any information in monetary and credit aggregates) is combined into inflation and output-gap forecasts that guide monetary policy. This means applying a flexible inflation-targeting strategy, precisely as has been done by and increasing number of central banks all around the world, including the Reserve Bank of New Zealand, the Bank of Canada, the Bank of England, Sweden's Riksbank, the Reserve Bank of Australia, the Swiss National Bank (since abandoning monetary targeting in December 1999, see [24]), the Bank of Norway (a new explicit inflation targeter since March 2001, recently reviewed by Svensson, Houg, Solheim and Steigum [23]), and many others. Furthermore, as convincingly argued by Goodfriend [7], the Federal Reserve System has for many years in practice followed a policy of "implicit" flexible inflation targeting, without an explicit inflation target and without being as transparent about it as other central banks.

The problems of the first pillar are by now so obvious and well-known and have been so thoroughly exposed in the many reports by ECB watcher groups and other commentators and analysts that there is no need to dwell further on them. I have discussed them myself in greater detail on numerous occasions, for instance, in Svensson [13], [15] and [20]. The Eurosystem's first pillar is simply such an unreliable indicator of future inflation that it is not worthy of separate pillar status. Its current unwarranted prominence in the Eurosystem's strategy and the resulting necessary excuses for and explanations of its poor performance requires the waste of considerable time, space, effort and other resources in ECB's press conferences, statements, publications and internal analysis. The ECB's monetary-growth pillar at most deserves to be one of many bricks in one single pillar combining all relevant information and indicators.

The adoption of an explicit flexible inflation-targeting strategy should also be accompanied by an improvement of the Eurosystem's transparency and reporting. As explained in some detail in Svensson [14] and [16], the ECB's *Monthly Bulletin* and the presentation of the Eurosystem's semiannual staff forecasts is much inferior to the *Monetary Policy Statements* and *Inflation Reports* of the inflation-targeting central banks, especially in comparison with the reports of the Reserve Bank of New Zealand, the Bank of England, the Riksbank and the Bank of Norway. The *Monthly Bulletin* should be improved. Every third *Monthly Bulletin* should be a genuine forward-looking *Inflation Report/Monetary Policy Statement* with extensive presentation, analysis and discussion of euro-area inflation and output-gap forecasts. The construction of the current semiannual Eurosystem staff forecast (which involves all Eurosystem central banks) is

an administratively complicated and slow process. It would be more efficient with the publication of a forecast by just the ECB staff or, better, the ECB Executive Board. This could be combined with comments by the Governing Council on the degree of its agreement with the Executive Board or staff forecast.

Minutes of Governing Council meetings should also be introduced. They should be modeled on the non-attributed minutes of the MPC of the Bank of England and the Executive Board of the Riksbank, which seem to work very well. This way outside observers can check that the discussions in the Council are of sufficient quality. Non-attributed minutes would improve transparency without preventing honest and frank exchanges. Such minutes should also include the Governing Council comments on the ECB Executive Board or staff forecasts.

3. Will the Eurosystem improve its strategy?

Thus, the answer to the question of how the Eurosystem *should* improve its monetary-policy strategy is obvious and simple. The Eurosystem should just adopt the much superior international-best-practice strategy of flexible inflation targeting, as it is demonstrated by the Reserve Bank of New Zealand, the Bank of England, the Riksbank and the Bank of Norway (which central banks, in my view, represent the international best practice of inflation targeting). The answer to the question of whether the Eurosystem *will* improve its strategy is more difficult. The Eurosystem has invested considerable prestige in a stubborn defense of its inferior strategy, most clearly manifested in the book by Issing, Gaspar, Angeloni and Tristani [9] but also in numerous speeches by Executive Board members and Governing Council members. This stubborn defense represents a huge waste of effort and resources and has, as far as I can see, been completely unproductive. Instead, the criticism of the strategy has steadily grown (and that from very high initial level), and the prestige and the respect of the Eurosystem has steadily deteriorated. Will the Eurosystem be able to abandon its stubborn defense, accept that bygones are bygones, and seek a genuine improvement of its flawed strategy? I sincerely hope so, but I am far from sure.

References

[1] Coenen, Günter, and Volker Wieland (2002), "The Zero-Interest-Rate Bound and the Role of the Exchange Rate for Monetary Policy in Japan," *Carnegie-Rochester Conference Series on Public Policy*, forthcoming.

[2] Duisenberg, Willem F. (1998), "The ESCB's Stability-Oriented Monetary Policy Strategy," speech in Dublin, November 10, 1998, www.ecb.int.

[3] European Central Bank (1998), "A Stability-Oriented Monetary Policy Strategy for the ESCB," Press Release, October 13, 1998, www.ecb.int.

[4] European Central Bank (2002), "Transcript of the Questions Asked and the Answers Given by Dr. Willem F. Duisenberg, President of the ECB, [and] Dr. Lucas Papademos, Vice-President of the ECB," press conference, December 5, 2002, www.ecb.int.

[5] Federal Reserve Bank of San Francisco (2003), *Fed Views*, January 9, 2003, www.frbsf.org.

[6] Federal Reserve Board (1996), *Federal Open Market Committee Transcripts: Meeting July 2–3, 1996*, www.federalreserve.gov.

[7] Goodfriend, Marvin (2003), "Inflation Targeting in the U.S.?" presented at the NBER Inflation Targeting Conference, January 2003.

[8] Issing, Otmar (2002), "ECB Watchers Conference: Monetary Policy and the Role of the Price Stability Definition," speech in Milan June 10, 2002, www.ecb.int.

[9] Issing, Otmar, Vitor Gaspar, Ignazio Angeloni and Oreste Tristani (2001), *Monetary Policy in the Euro Area*, Cambridge University Press.

[10] Meyer, Laurence H. (2001), "Inflation Targets and Inflation Targeting," speech, July 17, 2001, Federal Reserve Board, www.federalreserve.gov.

[11] New York Times (2002), "Oh So Quietly, Fed Ponders What Follows Greenspan," October 3, 2002, www.nytimes.com.

[12] Reserve Bank of New Zealand (2002), *Policy Targets Agreement 2002*, September 2002, www.rbnz.govt.nz.

[13] Svensson, Lars E.O. (1999), "Monetary Policy Issues for the Eurosystem," *Carnegie-Rochester Conferences Series on Public Policy* 51-1, 79–136.

[14] Svensson, Lars E.O. (2000a), "Forward-Looking Monetary Policy, Leading Indicators, and the Riksbank's Inflation Report vs. the ECB's Monthly Bulletin," Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, September 2000, www.princeton.edu/∼svensson.

[15] Svensson, Lars E.O. (2000b), "What is Wrong with the Eurosystem's Money-Growth Indicator, and What Should the Eurosystem Do about It?" Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, November 2000, www.princeton.edu/∼svensson.

[16] Svensson, Lars E.O. (2001a), "What is Good and What is Bad with the Eurosystem's Published Forecasts, and How Can They Be Improved?" Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, February 2001, www.princeton.edu/∼svensson.

[17] Svensson, Lars E.O. (2001b), "The Fed Does Not Provide the Solution to the Eurosystem's Problems," Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, May 2001, www.princeton.edu/∼svensson.

[18] Svensson, Lars E.O. (2001c), "Independent Review of the Operation of Monetary Policy in New Zealand: Report to the Minister of Finance," www.princeton.edu/˜svensson.

[19] Svensson, Lars E.O. (2002a), "Sweden and the Euro," Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, January 2002, www.princeton.edu/∼svensson.

[20] Svensson, Lars E.O. (2002b), "A Reform of the Eurosystem's Monetary-Policy Strategy is Increasingly Urgent," Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, May 2002, www.princeton.edu/∼svensson.

[21] Svensson, Lars E.O. (2002c), "A Good Thing Could Happen at the ECB: An Improvement of the Eurosystem's Definition of Price Stability," Briefing Paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, September 2002, www.princeton.edu/∼svensson.

[22] Svensson, Lars E.O. (2003), "Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others," working paper, www.princeton.edu/∼svensson.

[23] Svensson, Lars E.O, Kjetil Houg, Haakon Solheim and Erling Steigum (2002), "An Independent Review of Monetary Policy and Institutions in Norway," Centre for Monetary Economics (CME), Norwegian School of Management BI, www.princeton.edu/∼svensson.

[24] Swiss National Bank (1999), "Monetary Policy Decisions of the Swiss National Bank for 2000," Press Release, December 10, 1999, www.snb.ch.