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Possible improvements of the Eurosystem's monetary policy regime

Lars E.O. Svensson
www.princeton.edu/∼svensson
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- Points to consider
  - Goals
  - Framework for policy decisions
  - Communication: Forecasts
  - Accountability

- Goals
  - Current:
    - "Annual HICP increases below 2%": $0 \leq\ ? <$ inflation $< 2\%$
    - M3 reference value: Inflation target 1.5%
  - Problems:
    - Ambiguous and asymmetric
    - Zone of indifference? Thresholds for policy adjustment?
    - Imperfect anchor for inflation expectations

- Better:
  - Point inflation target: 1.5% (possibly tolerance interval: ±1%)
  - Thick point: 1–2% (Issing Milan!)
  - Unambiguous and symmetric
  - Better anchor for inflation expectations
  - No thresholds, gradual policy
  - "Avoid unnecessary output-gap variability"
  - Specify loss function: $L_t = (\pi_t - \pi^*)^2 + \lambda(y_t - \bar{y}_t)^2$
- Fed no model

- Framework for policy decisions
  - Efficient in collecting, processing information, reaching decisions
  - Effective in achieving goals
  - Because of lags: Inflation forecast 1–3 yrs ahead, conditional on alternative interest rate paths
  - Set interest rate so conditional inflation forecast (and output-gap forecast) "look good"
  - Riksbank, Bank of England: "If inflation forecast 1–2 years ahead above (below) target, raise (lower) instrument rate"
  - No reason for separate monetary pillar (incorporate in inflation and output-gap forecasts)

- Communication
  - Effective in motivation decisions, simplifying evaluation, increasing public understanding?
  - Explain and motivate policy in terms of inflation forecast
  - Publish inflation forecasts, including assumptions, inputs, uncertainty (distribution)
  - Transparency necessary for effective accountability
  - Published material similar to internal

- Current Eurosystem forecasts: Every 6 months
- Problems
  - Every 3(4) months better: ECB forecast between Eurosystem forecasts
  - Inconsistent assumptions
    - 3-month interest rate: constant
    - long interest rates: market expectations
    - exchange rate: constant
  - Brief/superficial report (longer report to GC?)
  - Minimal information
    - Table, average annual percentage changes
    - No graphs
  - Rudimentary uncertainty discussion/reporting

- Learn from Bank of England, Riksbank, RBNZ, Bank of Norway (Fed no model)
- But, room for improvements:
  - "Best forecasts" of inflation, output-gap, interest rate, exchange rate
    - Consistency, affect expectations, compare w/ outcome
    - 2nd best: Inflation and output-gap forecast conditional on market interest-rate expectations
  - 3-year horizon rather than 2
  - Mean forecasts rather than mode
  - Confidence intervals conditional on policy-response

- *Inflation Report* (quarterly, 4-monthly)
  - Current inflation relative to previous inflation forecast
    - Reasons for deviations
  - Updates of inputs in inflation forecast
    - Current inflation, output gap, unemployment gap, inflation expectations, wages, imported inflation, etc.
  - Update of inflation forecast
    - Risks, uncertainty, distribution
    - Policy alternatives
  - Output-gap forecast, avoid unnecessary variability
- Restructure *Monthly Bulletin*
  - Every 3rd (4th): *Inflation Report*
  - Between: Articles, report data

- Restructure monetary policy decisions/meetings: Quarterly, mid-quarter update

  (4-monthly, 2-month update)