Possible improvements of the Eurosystem’s monetary policy regime
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Points to consider
– Goals
– Framework for policy decisions
– Communication: Forecasts
– Accountability

Goals
– Current:
  * “Annual HICP increases below 2%”: 0 ≤ ? < 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: \( L_t = (\pi_t - \pi^*)^2 + \lambda(y_t - y^t)^2 \)

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
– 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

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)