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Monetary Policy and the Current Economic and Monetary Situation*

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What role does the current economic and monetary situation play in the assessment of Eurosystem monetary policy? What information about the current situation is relevant for such assessment? In answering such questions, one must bear in mind that monetary policy actions in industrialized countries normally affect real activity and inflation with considerable lags. As a very rough benchmark, it can be assumed that it takes about a year to affect output and about two years to affect inflation (except that effects transmitted through exchange-rate changes on CPI inflation takes less time). It then follows that current monetary policy actions of the Eurosystem should be assessed in view of the likely outcome in the euro area for inflation in about two years and output in about one year. Thus, forecasts of inflation and output are crucial for such assessment, as well as for conducting monetary policy in general.

It follows that the current economic situation, from the perspective of monetary-policy assessment, is relevant for two reasons:

1. For the assessment of *past* monetary policy (some two years ago), although that assessment is made more difficult because the current economic situation has also been also been affected by shocks occurring after those decisions were made and not known or anticipated at the time of those decisions.

2. For the assessment of *current* monetary policy, but only in so far as the current economic situation helps make forecasts of inflation about two years ahead and output about one

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year ahead.

It also follows that current euro-area inflation (12-month HICP inflation was 2.1 percent in March and 1.9 percent in April) has been affected by monetary-policy actions undertaken about two years ago, that is, in the spring and summer of 1998. Thus, decisions about those actions were taken about half a year before the Eurosystem took the responsibility for monetary policy in the euro area. Furthermore, current inflation has been affected by a number of shocks and events that have occurred after those actions were undertaken, most of which may have been unknown or unanticipated at the time of decision. These long lags in the effects and the intervening shocks make the ex post evaluation of monetary policy far from easy. In any case, we will largely have to wait until next spring to see euro-area inflation that has been affected by Eurosystem monetary policy.

Let us consider what kind of information is needed to assess current monetary policy. One aspect of monetary policy, its *credibility*, is relatively straight-forward to assess, in the cases when monetary policy has a well-defined goal. The Eurosystem's primary goal is price stability, and it has defined price stability as an annual increase in the HICP of less than 2 percent. Unfortunately, as many commentators have pointed out, this definition is ambiguous and asymmetric. In practice, the Eurosystem seems to use 1.5 percent as an inflation target, and a better, unambiguous and symmetric specification of its operational goal would be an inflation target of 1.5 percent, possibly with a tolerance interval of plus/minus 1 percent. Then, a relevant indicator of Eurosystem credibility is whether private-sector inflation expectations and (unconditional) forecasts two years ahead and more fall within the interval of 0.5–2.5 percent, the better the closer to 1.5 percent.

Thus, an assessment of the credibility of the Eurosystem requires data on private-sector inflation expectations for a two-year horizon and longer. Some issues in the ECB's *Monthly Bulletin* report inflation expectations derived from French nominal and real bonds, maturing in 2009. The difference between the nominal and the real yield is called the break-even inflation rate and has been fluctuating somewhat below 2 percent during 2000. Inflation forecasts of various forecasters are reported once a quarter (it seems). The assessment of Eurosystem credibility would be easier if the Eurosystem regularly reported a number of indicators of inflation expectations under one heading (for instance, "Inflation Expectations"), including surveys of inflation expectations for two-year horizons and longer.

Given the lags in the effects of monetary policy actions, for successful policy the Eurosystem needs to make inflation and output-gap forecasts two years ahead or longer. Similarly, for an appropriate assessment of Eurosystem *interest-rate setting*, one would need to check that a two-year-ahead inflation forecast for the euro-area HICP, conditional on the interest rate set by the Eurosystem, is not too far from 1.5 percent. In order to check that the Eurosystem does not induce too much volatility in the output gap, the output-gap forecast should also be checked.

The best situation for such assessment would be if the Eurosystem would publish its forecasts, including the underlying assumptions and analyses, in order to allow public scrutiny of these. Unfortunately, this is not the case today. However, the President of the ECB has several times promised to publish such forecasts during the current year.

A second-best situation would be if the Eurosystem would at least publish the main inputs of such an inflation forecasts. According to current conventional wisdom, future inflation is mainly determined by current inflation, inflation expectations, wage inflation, current and future output gaps, real euro depreciation (foreign inflation plus nominal euro depreciation less domestic inflation), indirect taxation changes, and various exogenous shocks. Future output is mainly determined by current output, the medium-term real interest rate, real euro depreciation, fiscal policy, foreign demand, and various exogenous shocks. The output gap is then output less potential output, where potential output is an unobservable variable that must be estimated with different methods.

Unfortunately, although the Eurosystem publishes a fair amount of data in its *Monthly Bulletin*, it does not systematically publish the main inputs of inflation and output-gap forecasts. The information published is not sufficiently complete (for instance, GDP growth is reported, but not the various estimates of potential output and the output gap). In particular, *the information is not systematically organized in a way to facilitate the assessment of Eurosystem monetary policy.* The contrast with the publications of some of the explicitly inflation-targeting central banks, especially Bank of England, Reserve Bank of New Zealand and Sveriges Riksbank (the central bank of Sweden), is striking. For instance, the quarterly *Inflation Report* of Sveriges Riksbank is organized in line with the Bank's view on how inflation is determined, and the different inputs in the inflation forecast are systematically presented, updated and discussed, culminating in the presentation of the bank's inflation forecast for the next two years.

Unless the Eurosystem provides more adequate information, independent assessment of Eurosystem monetary policy by the ECON committee may require a staff with independent capacity to construct forecasts of inflation and the output gap.