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The Fed Does Not Provide the Solution to the Eurosystem's Problems*

Lars E.O. Svensson
Institute for International Economic Studies, Stockholm University;
CEPR and NBER;
Homepage: www.iies.su.se/leosven

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The Eurosystem has serious problems with its strategy and its monetary policy. Some may think that the Federal Reserve System provides a solution to the Eurosystem's problems. This is hardly the case.

The Eurosystem has problems with its monetary-policy strategy. The definition of price stability is problematic. It provides a range for HICP inflation, by the words "increases below 2%," but these words are more precise about the ceiling than the floor (is the floor zero or not?). Therefore, the definition is asymmetric. Furthermore, a range is inferior to a point inflation target, since a range may be interpreted as a "zone of indifference" and the edges of the range may be interpreted as "hard-edged," that is, thresholds for policy adjustments. A range provides a less precise anchor for inflation expectations. There is a big difference between inflation expectations of 2% and 0%. For instance, wage negotiation differences are often about a few tenths of a percent, and the starting point for the negotiations (expected inflation plus expected productivity growth) are important.

A symmetric point target provides the best anchor for inflation expectations. Symmetry, in the sense of being equally concerned about over- and under-shooting the target, is necessary for avoiding a bias in inflation expectations relative to the target. The zero lower bound for interest rates, the risk for a liquidity trap and the experience of Japan all point to the dangers of too low inflation and, in particular, deflation expectations. If a range is announced around the point

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target, it is important that the edges are interpreted as "soft-edged" and not as thresholds for policy adjustment, thus allowing for a gradual and medium-term approach to monetary policy.

The Eurosystem actually uses a point target, namely 1.5%, when it calculates the reference value for M3 growth. This point target is only 0.5% below the ceiling of 2%, making it likely that the ceiling will often be exceeded, which has been the case for about a year now. For symmetry, the point target should be in the middle of the target range. With a ceiling of 2%, this would be the case only if the target range would be as narrow as 1–2% (which, however, would be inconsistent with ECB statements in the fall of 1998—when inflation was around 1%—that current inflation was consistent with the definition of price stability). These circumstances add to the ambiguity and asymmetry of the Eurosystem's definition of price stability.

The best way out of this dilemma would be an explicit, unambiguous and symmetric point target of 1.5%, with or without a tolerance interval of ±1%. This would be in line with the formulations in the U.K. (a point target of 2.5%, with a requirement of an explanatory letter from the Bank of England if inflation deviates more than 1 percentage point from the target) and Sweden (a point target of 2% with a tolerance interval of ±1%). It is more important to have an explicit point target, and hence a precise nominal anchor, than whether that target is 1.5, 2 or 2.5%.

The Eurosystem has problems with its unfortunate choice of a two-pillar monetary-policy strategy, which continues to be severely criticized by practically all external observers and commentators.[1] As has been said over and over again, the only sensible choice is a one-pillar strategy where all relevant information (including money and credit aggregates), is combined into constructing inflation and output-gap forecasts to guide monetary policy, precisely as the Bank of England, the Swedish Riksbank, the Swiss National Bank (since abandoning monetary targeting in December 1999, see [10]), the Bank of Norway (a new explicit inflation targeter since March 2001, see [8]), among others, do.

The Eurosystem also has problems with its actual monetary policy. It is currently subject to considerable pressure to lower the interest rate, as a response to deteriorating prospects for the real economy. Current inflation is substantially above the 2 percent ceiling, though, which some would refer to as a reason for not easing monetary policy. (The current output gap, although a very important statistic, is not reported by the ECB or the Eurostat.) However, given the lags in the effects of monetary-policy adjustments on the economy, perhaps a year for output and

[1] For recent examples, see Alesina, Alberto, Olivier Blanchard, , Jordi Galí, Francesco Giavazzo, and Harald Uhlig [1], Blinder, Goodhart, Hildebrand, Lipton, and Wyplosz [4], and Galí [6].

perhaps two years for inflation, the issue is not what current inflation and the output gap are, but what they will be in one and two years ahead. That is, the best current monetary-policy setting depends on inflation and output-gap *forecasts* one and two years ahead (the one-and-only pillar needed). The Eurosystem needs to set the interest rate so that corresponding inflation and output-gap forecasts "look good," that is, the inflation forecast being consistent with the definition of price stability about two years ahead and the output-gap forecast not indicating too much variability of the output gap.

The Eurosystem does not motivate its monetary policy with the help of published inflation and output-gap forecasts open for scrutiny.[2] This lack of transparency makes it difficult for it to motivate and defend its interest-rate settings, and also makes it difficult for external observers to evaluate Eurosystem decisions. The result is an unsophisticated and uninformed debate. Another result is often an element of surprise, as when the Eurosystem reduced the interest rate on May 11, apparently counter to previous ECB rhetoric. Such a surprise is a good indication of bad communication and low transparency.

Given these problems of the Eurosystem, does the Federal Reserve way of doing monetary policy offer a solution? It does not.

The Federal Reserve Act provides the Fed's legal mandate. It specifies that, in conducting monetary policy, the Federal Reserve System and the Federal Open Market Committee should "seek to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Arguably these goals are inconsistent, and a clarifying interpretation would be needed. The Fed has chosen not to provide one.[3] In particular, the Fed has not provided a precise definition of price stability. Thus, there is no precise nominal anchor. As expressed by Mishkin [7]: "I think it is fair to say that the nominal anchor in the United States right now is Alan Greenspan. The problem is that this leaves some ambiguity as to what the Fed's target is, and even more importantly, the existence of this implicit nominal anchor depends on personalities. Alan Greenspan, despite his recent reappointment, will not be around for ever. When he steps down, will the public believe that there is a sufficient commitment to a nominal anchor to keep inflation from appearing again?"[4]

[2] As discussed in Svensson [9], the new publication of ECB staff forecasts every six months, although a promising beginning, goes only part of the way.

[3] One possibility would be to say that "stable prices" is specified as 2% inflation. "Maxium employment" is specified as "maximum *sustainable* employment," the natural rate of employment, which is determined by other factors than monetary policy. "Moderate long-term interest rates" will result from achieving credible low inflation. Thus, the objectives boil down to "flexible inflation targeting," namely stabilizing inflation around the inflation target, while avoiding unnecessary variability of employment around the natural employment rate, or of the output gap.

[4] Similar concerns and suggestions to introduce a formal inflation target are presented in Bernanke, Laubach,

As recently discussed in Blinder, Goodhart, Hildebrand, Lipton, and Wyplosz [4], although the Fed has become less tight-lipped, secretive and cryptic in recent years, it still has much lower standards of transparency than the inflation-targeting central banks and the Eurosystem, too. Adapting Fed standards would be a significant step back for the Eurosystem. The market and external observers still convey a sense of understanding Fed policy. This is probably due to a certain degree of consistency over a long time in the policy of its long-time and dominating Chairman, which have given ample time for learning, rather than to good explanations.

Actual Fed policy seems to have been successful, in the sense of controlling inflation during a long expansion and a long period of gradually falling employment. Since Fed analysis, forecasts and motivations are not provided in any detail to outside observers, it is difficult to judge whether this is due to skill or luck. It is also not clear to what extent the Fed is concerned about asset prices separately from their effect on inflation and output. There are arguably signs of increasing activism and increasing weight on fine-tuning of output, with less concern given to headline and core inflation trending upwards in recent years. This would also be a step back for the Eurosystem.

Thus, the Fed way does not provide a solution to the Eurosystem's problems. Although the solution is available across water, is not to be found across the Atlantic. It is available much closer, across the English Channel and the Baltic, at the Bank of England and the Riksbank.

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