

# A Good Thing Could Happen at the ECB: An Improvement of the Eurosystem's Definition of Price Stability\*

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## Abstract

The Eurosystem's definition of price stability, "HICP increases below 2%," is ambiguous and asymmetric, and less effective as an anchor for inflation expectations than a point inflation target. A speech of Otmar Issing's in Milan, June 2002, can be interpreted as a modification of the definition as "HICP inflation of 1-2%." This would make the definition of price stability unambiguous and symmetric and, for several reasons, be a significant improvement.

As noted by many observers and argued in Svensson [7], a reform of the Eurosystem's monetary-policy strategy is increasingly urgent. The strategy has a "definition of price stability" and "two pillars." Both the definition of price stability and the two pillars need to be reformed.

Regarding the *two pillars*, as has been said over and over again (including in [7]), 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, precisely as is done by, among others, the Bank of England, the Swedish Riksbank, the Swiss National Bank (since abandoning monetary targeting in December 1999, see [9]), and the Bank of Norway (a new explicit inflation targeter since March 2001, recently reviewed by Svensson, Houg, Solheim and Steigum [8]).

The Eurosystem's definition of price stability is "an increase in harmonised consumer prices of below 2%." As discussed in [7] and in some more detail in Svensson [5], the definition of price stability is problematic, because it is ambiguous and asymmetric, and therefore less effective as an anchor for inflation expectations. A symmetric explicit point inflation target, say 1.5%,

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2% or 2.5%, would be better and provide a better anchor for inflation expectations. Having an explicit point target is more important than the precise level of the target, 1.5, 2 or 2.5%. As long as there is a clear point target to aim for, it is not important whether there is range or not. Unanticipated shocks will in any case make *ex post* inflation deviate from the target.

The definition is *ambiguous* because it is unclear about the lower bound of the inflation range. About a month after the definition was announced on October 13, 1998 (European Central Bank [2]), Duisenberg [1], 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 [3] words, the Eurosystem has been "maintaining flexibility as to the lower bound." The definition is *asymmetric* because the upper and lower bounds are not announced with the same precision; the upper bound is precise whereas the lower bound is imprecise. 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. An unambiguous and symmetric definition would be, for instance, "an increase in harmonised consumer prices of between  $x$  and  $y$ ."

Interestingly, a speech by Issing [3] at the Conference on ECB and Its Watchers IV in Milan, June 2002, could be interpreted as a modification of the definition to a symmetric one, where  $x$  is 1% and  $y$  remains 2%. 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 Svensson [6], for instance, 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 [4] for details of the calculation). Indeed, the Eurosystem is probably best interpreted as having an effective point inflation target of 1.5%, so the 1–2% is completely consistent with this.

Why could Issing's speech be interpreted as specifying 1–2%? In discussing the Eurosystem's definition of price stability with reference to the lower zero bound in nominal interest rates and the risk of a deflationary spiral, Issing [3] states (emphasis added):

"Research has not clarified yet the extent to which pursuing an inflation objective closer to zero indeed implies substantially larger risks of getting trapped in a deflationary spiral. What is clear is that a small positive inflation rate, *say between 1 and*

*2 percent*, substantially reduces such potential risks. For example, some research, discussed at the First ECB Central Banking Conference on Why price stability?, suggests that the zero-bound constraint would in practice only rarely be encountered in the euro area. On the basis of the shocks experienced in the euro area in the past and given estimates of the equilibrium real interest rate, most of the problems associated with the lower bound on nominal interest rates could be avoided for *rates of inflation as low as 1%*. It is important to note that also here the credibility of the central bank plays an important stabilizing role by maintaining stable inflationary expectations.”

Ending his discussion about the desirability of small positive inflation (which covers measurement bias, the lower zero bound, and the scope for relative price changes), Issing [3] states (emphasis added):

“Reviewing the various arguments in favour of a small positive inflation rate and their application to the euro area, it is clear that there is still a lot of uncertainty about what may happen when HICP inflation moves down towards zero percent. In view of these uncertainties, the central bank should be vigilant *when inflation falls towards an excessively low level, say below 1%. ...*”

These quotations mention 1% three times in a not-so-long speech. Furthermore, below 1% is associated with “an excessively low level.” Would the Eurosystem contemplate having a lower bound lower than 1%, if that would allow inflation at an excessively low level?

Need we hear more to conclude that the lower bound is 1%? At least we *should* hear more, and hear it more clearly. It is a shame and reflects badly on the transparency of the Eurosystem, if external observers have to resort to word-for-word analysis of this kind in order to find the true objectives of the Eurosystem (cf. the detailed interpretations that Federal Reserve Chairman Greenspan’s speeches are sometimes subject to). In this new era of most welcome monetary-policy transparency, one should not have to resort such methods.

## References

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