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In the Right Direction, But Not Enough: The Modification of the Monetary-Policy Strategy of the ECB:*

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Abstract

The ECB has missed an opportunity to thoroughly modernize its monetary-policy strategy and reach best international practice. The change in the definition of price stability to "below but close to 2%" is an improvement, but some completely unnecessary ambiguity remains. The reduction of the prominence of monetary aggregates is in the right direction, but it would be better to combine the two pillars to one and explicitly adopt flexible inflation targeting.

At the ECB's press conference on December 5, 2002, ECB President Willem Duisenberg unexpectedly announced, in response to a question, that the ECB would undertake "a serious evaluation" of its monetary policy strategy (ECB [3]). This evaluation can be seen as a response to the strong and almost unanimous criticism of the ECB's strategy from the ECB's outside observers and commentators, both academic and nonacademic. I have contributed to this criticism myself, for instance, in previous briefing papers for ECON available on my homepage and in [9]. In Svensson [11], I suggested two reforms of the strategy:

1. Modify the asymmetric and ambiguous definition of price stability, "year-on-year increases in the HICP of below 2% in the medium term," and adopt a symmetric inflation target of either 1.5 or 2%.

2. Abandon the outdated two-pillar strategy, incorporate the first pillar ("the prominent role of money with a reference value for M3 growth") into the second ("the broadly-based assessment of the outlook for future inflation") and adopt flexible inflation targeting.

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I ended [11] by expressing some doubts about the willingness of the ECB to reform: “Will the Eurosystem be able to abandon its stubborn defense [of the strategy], accept that bygones are bygones, and seek a genuine improvement of its flawed strategy? I sincerely hope so, but I am far from sure.”

At the ECB’s press conference on May 8, 2003, Duisenberg and ECB Chief Economist Otmar Issing presented the results of the evaluation and the Governing Council’s decisions on the strategy (ECB [5] and [6]). They boil down to:

1. Maintaining a less but still somewhat ambiguous definition of price stability by modifying the existing one to “below *but close to* 2%.”

2. Keeping the two-pillar strategy but reducing the prominence of the first pillar by putting it second and discussing the monetary pillar (relabeled “monetary analysis”) after the “broadly-based assessment” (relabeled “economic analysis”), seeing it mainly as a means of “cross-checking” the “economic analysis”.

This is a change in the right direction, but it is not enough. As noted by de Grauwe [1], the ECB has missed an opportunity to thoroughly modernize its strategy, remove the ambiguity, and explicitly and transparently adopt flexible inflation targeting. As de Grauwe points out and as is clear from the transcripts of the press conference, Issing even denies that there is a change in the strategy: it is just “a clarification”, the ECB has “confirmed [its] two-pillar approach,” and “this is totally different from what is normally seen as inflation targeting.”

Predictably, the first question about the new strategy at the press conference was, “what does this mean?”

> Professor Issing, what does “close to 2%” mean in the definition of price stability? Is it a little bit less than 2%, on average, in the medium term or is it a pure inflation target now?

Issing’s answer was:

> Certainly not. We have confirmed our two-pillar approach. This is totally different from what is normally seen as inflation targeting. And second, this “close to 2%” is not a change, it is a clarification of what we have done so far, what we have achieved – namely inflation expectations remaining in a narrow range of between roughly 1.7% and 1.9% – and what we intend to do in our forward-looking monetary policy.

Issing’s answer raises several questions: First, it would seem that “below but close to 2% in the medium term” would mean a medium-term inflation targeting of, say, 1.9% or 1.8%, depending on how one defines “close”. Why not say what it means, and remove the remaining ambiguity of "close". What is the point of this ambiguity? There is less ambiguity than before ("below but close to two" is less ambigous than "below two"), but why not go all the way? Everyone should know these days that having a precise inflation target, whether a point or a target range, has no downside. Everyone should know that real-world inflation targeting is always in practice "flexible" medium-term inflation targeting. "Medium term" is actually redundant, since all "flexible" inflation targeting is "medium term." Inflation targeting does not mean that inflation in the short run always has to be on target. ("Strict" short-term inflation targeting is only a simplifying assumption occasionally used in formal models of inflation targeting.)

Second, Issing, when clarifying the new definition, refers to "inflation expectations remaining in a narrow range of roughly between 1.7% and 1.9%." In line with this, the slides used by Issing in his presentation show graphs of long-term expectations of inflation in the Euro area (from Consensus Forecasts and from ECB's Survey of Professional Forecasters) that fall roughly between 1.7% and 1.9% during 1999-2002. But *expectations* of inflation is not the same thing as *actual* inflation. The proximity of inflation *expectations* to an inflation target is a measure of the *credibility* of the inflation target. It is not the inflation target itself. Expectations of long-term inflation falling below 2% for the euro area is an indication of the credibility of the definition of price stability, but it is distinct from the definition itself. Unless, God forbid, the definition of price stability is revised to refer to *expectations* of inflation rather than *actual* inflation. This is not the way to remove ambiguity.

Third, is "close to 2" really "no change"? Was the definition "close to 2" all the time, only that the ECB did not bother to say so? In order to examine this, consider the first announcement of the ECB's monetary policy strategy on October 8, 1998, when "below 2" was first stated. The press release also included the statement (ECB [2]):

> The current rate of HICP inflation in the euro area is in line with this objective [the definition of price stability].

At the time, in September and October, 1998, HICP inflation was about 1%. Is this "close to 2"? Because of the above statement, one interpretation in Svensson [9] was that "increases below 2%" meant a target range of 0 to 2 or, equivalently, a point inflation target of 1. However, [9] also noted that the ECB's calculation of its reference value implied an inflation target of 1.5%. Thus, another interpretation of "below 2" was a point target of 1.5 or, equivalently, a target range of 1 to 2. Furthermore, as argued in Svensson [10], a speech by Issing [8] in June 2002 can be interpreted as endorsing "1 to 2". An answer by Duisenberg to Mrs. Randzio-Plath at the hearing at the European Parliament in February 2003, [7, p. 11], also seems to endorse "1 to 2", equivalent to a point target of 1.5. Is 1.5 "close to 2"? Is there really no change? What is the point of all this ambiguity? *Why not just say* 2 *and say that it is change*?

As for the two pillars, the ECB's modest modifications and change in the presentation order gives the ECB some flexibility to reduce the prominence of the monetary aggregates in its analysis and reporting. The ECB has wisely also decided to discontinue the conspicuous annual announcement of the reference value for M3 growth by the Governing Council. This will allow the ECB to reduce the emphasis of the reference value and avoid the continuous embarrassment this has caused. It would have been better to throw the reference value on the garbage heap of history where it belongs.

Furthermore, the new labelling, "economic analysis" and "monetary analysis", is perhaps not the best. Is the "economic" analysis (which would include the construction of inflation projections, the cornerstone of a monetary policy aimed at low and stable inflation) really "nonmonetary" analysis? More pointedly, is the "monetary" analysis (which would include the construction of inflation projections with the help of monetary aggregates) really "noneconomic" analysis? As I have argued many times, it would be better to combine all the information from all the indicators, let each indicator have a weight corresponding to its information content, and construct the best available inflation projections, rather than artificially separating the indicators into two pillars.

On May 8, the ECB also made available a large amount of background material related to the evaluation of the strategy (ECB [4]). The excellent staff of the ECB has produced an impressive set of very good and informative background papers, listed and available on the ECB's website. These background papers are of great general interest and deserve to be widely read. It is a pity that, after this fine work by the staff, the Governing Council has decided on such small improvements of the strategy.

The ECB and the Eurosystem still has a way to go before its strategy catches up with best international practice (which, by the way, everyone can see demonstrated in Europe by the Bank of England, the Riksbank and the Bank of Norway).

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