The New Monetary Policy Strategy of the ECB[1]

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Background

The Treaty establishing the European Union mandates price stability as the primary objective of the ESCB. On 13 Oct. 1998, the Governing Council of the ECB announced the main elements of its plan for attaining this objective. On 8 May 2003, after four years experience conducting monetary policy, the Council has announced a significant change in its monetary policy strategy.

The original strategy consisted of three elements. First, the Council provided a formal technical definition of price stability. Second, money growth was assigned a prominent role in the assessment of the risks to price stability. This was known as the *first pillar* of the ECB's monetary policy. Third, there was also to be a broadly based evaluation of the threat to price stability, using a wide array of economic and financial variables. This was the *second pillar*. In addition to these three elements, the Council announced that it would ensure the transparency of its decision-making process and its accountability by keeping the public informed about its assessment of the economic situation and the reasoning behind its decisions.

The revised strategy contains two important alterations. First, there has been a change in the definition of price stability that leaves it both more precise and more relaxed. Second, the special importance of money growth in appraising the danger to price stability has been abandoned. While both of these changes are important and likely to be beneficial, the revision in strategy does not go far enough. There is still room for further improvements in the design of euro-area monetary policy.

Changing the Definition of Price Stability

The original 13 Oct. 1998 definition of price stability was yearly inflation, as measured by the Harmonised Index of Consumer Prices (HICP), for the euro area of less than two percent. The 8 May 2003 press release announces that the ECB will keep this definition, but adds the "clarification" that it will seek to maintain the inflation rate at close to two percent. This presentational slight of hand should fool no one; this is a distinctly dovish change in policy.

When it was originally announced that inflation was to be kept at less than two percent, the natural interpretation was not that the ECB was aiming to keep inflation just below two percent. Given the floor of zero, the obvious interpretation was that the ECB was aiming for about one percent and viewed the costs of deviating from this as rising sharply as inflation either rose to two percent or fell to zero percent.

Is this announced change in the conduct of monetary policy desirable? There are two important aspects to the revision that can be addressed separately. First, the inflation objective was relaxed; second, it was made more precise.

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[1]Briefing paper for the Committee on Economic and Monetary Affairs (ECON) of the European Parliament for the quarterly dialogue with the President of the European Central Bank.

From a short-run point of view, the relaxation of the inflation objective from what I will infer to be about one percent to near two percent is wise. HIPC inflation has averaged 1.95 percent per year over the period 1999 - 2002. For the year 2002, it was 2.3 percent and it was 2.4 percent for March 2003 on an annualised basis. Reducing inflation to one percent would require significant tightening. Given Europe's current economic doldrums and the surging of the euro, this could not be recommended.

The easing is sensible from a long-run point of view as well. One reason is that measured inflation is likely to overstate actual inflation. There are several reasons for this. First, price indices are calculated by comparing the price of a basket of goods consumed in a base year with the price of the same basket consumed in the current year. This overstates inflation because it does not take into account that consumers change their consumption as prices rise.[2] Second, improvements in the quality of goods may cause price changes to overestimated. Third, prices of new goods often fall rapidly in the first few years after their introduction. It may be several years before goods are included in the basket of goods used to calculate the price index, and thus the fall in their prices may be missed. Fourth, consumers may switch from buying a good at one outlet to another outlet which introduces a lower price. That they do so indicates that any inconvenience is worth the lower price that they pay. If the index only uses prices from the old outlet, then it does not take this price decrease into account.

A recent study by Lebow and Rudd (2003) estimates that the size of the upward measurement bias is about 0.9 percentage points for the United States, with a plausible range of about 0.3 to 1.4 percentage points. The Boskin report (1996) suggests a bias of 1.1 percentage points. Shiratsuka (1999) estimates that the bias for Japan is 0.9 percentage points, with a plausible range of about 0.35 to 2.00 percentage points. Evidence for the the size of the HICP bias is scant, but if it is similar to the estimated biases for the United States and Japan then estimated inflation of one percent may be consistent with actual price deflation.[3]

Even if one percent inflation is consistent with actual inflation that is strictly positive, it is low enough that an unanticipated shock might cause deflation to occur. With significant inflation differentials within the euro area it is also possible for some countries to experience deflation, even if the euro area as a whole does not. The International Monetary Fund (2003) assess the risk of mild measured inflation in Germany over the next year as "considerable".

Deflation shares many of the costs of inflation. The "menu costs" associated with changing prices occur whether prices go up or down. To the extent that inflation and deflation are unanticipated they both redistribute income. Inflation redistributes it from creditors to debtors; deflation redistributes it from debtors to creditors.

The costs of inflation and deflation may not be symmetric however; low deflation may be far

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[2]The HICP is a chain-linked Laspeyres index similar to the United Kingdom's RPIX and the United State's CPI. Germany, Greece, Spain, Ireland, Austria and Finland rebase their indices every five years; other euro-area countries do it more frequently. The United States rebases its index every two years. In addition to the *upper-level substitution bias* just described there is a lower-level bias arising from the way in which the narrowest components of price indices are derived. The direction of this bias is less obvious.

[3]The size of the biases suggest that efforts spent improving HICP may be worthwhile. An additional glaring defect of the index is that it does not include owner-occupier housing services.

more costly than low inflation. The redistribution of wealth from debtors to creditors may be especially costly. Defaults may occur and the resulting bankruptcies and restructurings destroy real wealth.[4] In addition, imperfect information in credit markets means that borrowers with strong balance sheets can attain loans more easily and at less cost than borrowers with weaker balance sheets. The deterioration in debtors' balance sheets brought about by unexpected deflation thus lowers both consumption and investment demand. Mishkin (1997) argues that deflation has been a key factor in the promotion of financial instability in inustrial countries.[5]

Another reason for preferring an operational objective of two percent to one significantly lower is that it gives the ECB more room to maneuver. Even with current inflation, the ECB's repo rate is only 2.5 percent. One can imagine the euro area being hit by a sufficiently contractionary shock that the ECB would want to lower its interest rate by more than 250 basis points and being constrained by the zero lower bound on nominal interest rates. This scenario is not the just the figment of an academic's imagination; the current US Fed funds rate of rate of 1.25 percent and short-term Japanese interest rates of zero provide real-world evidence of its plausibility. The situation could be resolved by monetising the public debt, open-market purchases of a wide range of securities, tax cuts financed with base money or the imposition of a carry tax on currency. However, these solutions are likely to be more difficult or costly to implement than simply changing a short-term interest rate and the outcomes are apt to be less predictable.[6]

Making the inflation objective more clearly defined is also to be welcomed, but the change is not enough. The asymmetry of the objective – close to, but not above two percent – is a source of weakness. As just argued, significant downward deviations from a low target are likely to be at least as costly as upward deviations. It is difficult to understand why the ECB is so reluctant to describe and formalise its operational objective as an inflation target. Perhaps it has an aversion to suggesting that any positive amount of inflation is desirable. However, if welfare is maximised at zero inflation and it is likely that measured inflation overstates actual inflation then welfare is maximised at some strictly positive measured rate of inflation. If the costs of deviating on the downside are significantly greater than the costs of deviating on the upside, then this suggests that the ECB should be aiming at a measured rate which is even higher than the one that produces zero actual inflation.

Demotion of the First Pillar

In its 13 Oct. 1998 press release the Governing Council of the ECB assigned a prominent role to money in its monetary policy strategy. The Council stated that it would announce a reference value for a broad monetary aggregate that would be consistent with and that would serve to achieve price

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[4]Weiss (1990) estimates that the direct costs of bankruptcies can eat up over three percent of the value of the debt and equity of large firms; indirect costs can be even higher.

[5]It is sometimes argued that downward, but not upward, rigidities in prices are an additional reason that deflation is more costly than inflation. However, the existence of distortions is not well understood and current downward rigidities may be the result of a lack of recent experience with deflation.

[6]See Buiter (2003) for a discussion of how economies can be cured of deflation.

stability. While the Council did not commit itself to always meeting this target over the short term, it stated that deviations would normally signal a threat to meeting its inflation objective. On 8 Dec. 1998, the Council announced that the reference value would refer to M3 and that it would initially be 4-1/2 percent. This reference value was left unchanged at the Council's annual reviews. It is likely that the role of M3 was viewed primarily as a mechanism for the Council to communicate its monetary policy strategy to the public, and thus as a way for the Council to be seen as transparent and accountable.

In its 8 May 2003 press release the Council announced that the introductory statement of the President at the ECB Press Conference following a Governing Council rate-setting meeting will now start with an analysis identifying the short- to medium-term risks to price stability. There is no special role for M3 or any other monetary aggregate in this analysis. This will be followed by an assessment of the medium- to long-term risks to price stability. This will take into account developments in M3 and other monetary indicators. Quite sensibly, the Council says that it will view this analysis primarily as a means of cross-checking, from a longer-term perspective, the indications of the shorter-term analysis. The short- and medium-term assessment will be called the *economic analysis*; the longer-term assessment will be called the *monetary analysis*. The most telling indicator of the downgrading of importance of M3 is that the Council will no longer conduct annual reviews of its reference value.

The demotion of M3 is to be welcomed. Assigning a prominent role to M3 and providing a reference value for it is only reasonable if there is a consistent relationship between this variable and inflation. Unfortunately, the relationship between M3, or any other measure of money, and inflation is highly unstable. This leaves a central bank that is primarily concerned with price stability and that wants to target or provide a reference value for a monetary aggregate with three choices. It can constantly revise its monetary target; it can sacrifice price stability; or, it can repeatedly miss its monetary target. The ECB chose the third alternative, regularly exceeding M3 growth of 4-1/2 percent. This made M3 a poor signal of monetary policy and did not promote the Council's goal of being transparent and accountable.

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