A true strategy for the ECB

Peter Bofinger
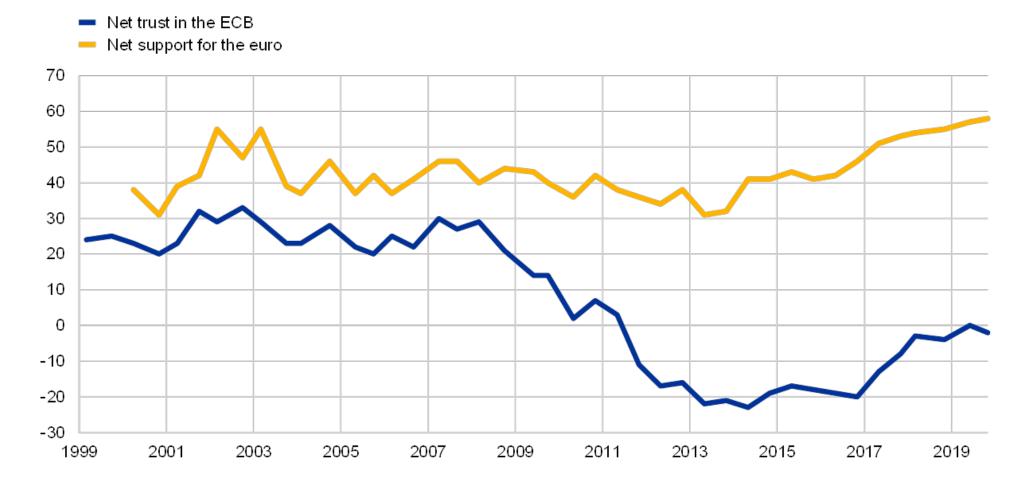
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Comprehensive strategic review of the ECB

Already in her first press conference on 12 December 2019, Christine Lagarde announced a comprehensive strategic review. This, she said, 'needs to look at all and every issue, will turn each and every stone and will take its time but will not take too much time'.

Christine Laga
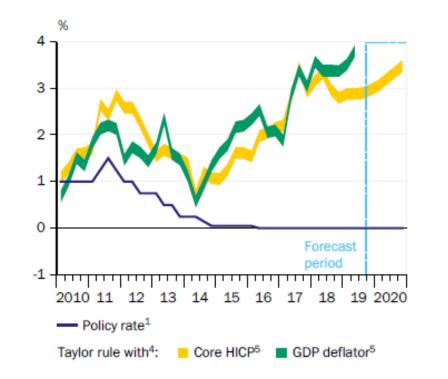
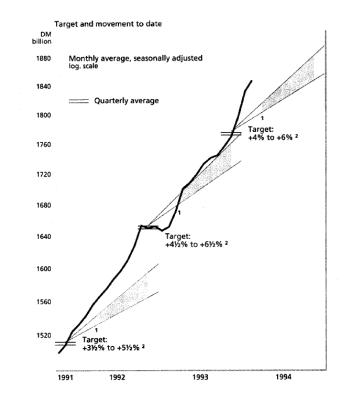# Net trust in the ECB lower than in 1999

What is the purpose of a strategy?

- "(….) a comprehensive framework within which decisions on the appropriate level of short-term interest rates are taken." (ECB, https://www.ecb.europa.eu/mopo/strategy/html/index.en.html)

- A strategy can be compared to a **heuristic**: a simple rule that reduces the complexity of difficult decision processes

- Heuristics in monetary policy:
  - **Monetary targeting** reduces decision-making to the comparison of the actual monetary growth rate to a target growth rate that is compatible with non-inflationary long-term economic growth
  - **Taylor-Rule** reduces decision-making to the comparison of the actual short-term interest with an optimum rate, calculated as a neutral rate plus adjustments for the inflation-gap and the output gap
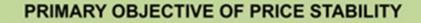
The experience with the two monetary policy rules
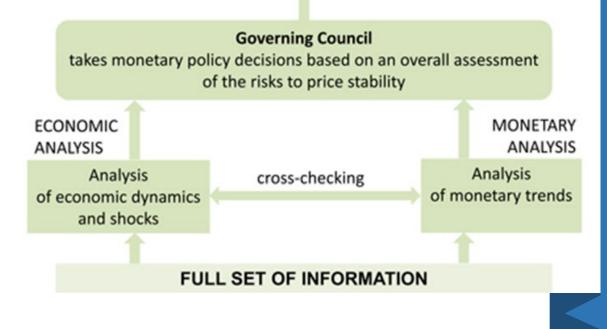
Taylor rule for the euro area

M3 rule for Germany (1991-94)

Source: German Council of Economic Experts (2019) and Deutsche Bundesbank (1994)

The two-pillar strategy of the ECB

Source: https://www.ecb.europa.eu/mopo/strategy/html/index.en.html

Two pillars stating the obvious, but provide no reduction of complexity

- **Economic analysis** assesses short to medium-term determinants of price developments.
- To do so, the ECB reviews, inter alia,
  - developments in overall output
  - demand and labour market conditions
  - bond prices and the yield curve
  - a broad range of price and cost indicators,
  - business and consumer surveys
  - fiscal policy, and
  - the balance of payments for the euro area.

- **Monetary analysis**: a detailed analysis of monetary and credit developments with a view to assessing their implications for future inflation and economic growth.
- (…) using a broad set of tools and instruments that are continuously refined and expanded.
- The tools and instruments include a comprehensive analysis of the developments of the monetary aggregates, particularly those of the broad aggregate M3, (…).

Reference value for M3: The unhappy heritage from the Bundesbank

Money stock M3: reference value and actual growth rate

Target 4.5 % — **M3 Growth rate**

Source: Deutsche Bundesbank

Why not try inflation targeting?

- "Establish explicit **quantitative targets for inflation** for a specific number of periods ahead.
- Indicate clearly and unambiguously to the public that **hitting the inflation target takes precedence** over all other objectives of monetary policy.
- Set up a model or methodology for **inflation forecasting** that uses a number of indicators containing information about future inflation.
- Devise a **forward-looking operating procedure** through which monetary policy instruments are adjusted (in line with the assessment of future inflation) to hit the chosen target."

COUNTRY	INFLATION TARGETING ADOPTION DATE	TARGET IN-FLATION RATE AT TIME OF ADOPTION	COUNTRY	INFLATION TARGETING ADOPTION DATE	TARGET IN-FLATION RATE AT TIME OF ADOPTION
New Zealand	1990	1−3	Philippines	2002	4+/−1
Canada	1991	2+/−1	Guatemala	2005	5+/−1
United Kingdom	1992	2 (point target)	Indonesia	2005	5+/−1
Australia	1993	2−3	Romania	2005	3+/−1
Sweden	1993	2 (point target)	Serbia, Republic of	2006	4−8
Czech Republic	1997	3+/−1	Turkey	2006	5.5+/−2
Israel	1997	2+/−1	Armenia	2006	4.5+/−1.5
Poland	1998	2.5+/−1	Ghana	2007	8.5+/−2
Brazil	1999	4.5+/−2	Uruguay[1]	2007	3−7
Chile	1999	3+/−1	Albania	2009	3+/−1
Colombia	1999	2−4	Georgia	2009	3
South Africa	2000	3−6	Paraguay	2011	4.5
Thailand	2000	0.5−3	Uganda	2011	5
Hungary	2001	3+/−1	Dominican Republic	2012	3−5
Mexico	2001	3+/−1	Japan	2013	2
Iceland	2001	2.5+/−1.5	Moldova	2013	3.5−6.5
Korea, Republic of	2001	3+/−1	India	2015	2−6
Norway	2001	2.5+/−1	Kazakhstan	2015	4
Peru	2002	2+/−1	Russia	2015	4

Source: https://www.imf.org/external/pubs/ft/fandd/basics/pdf/jahpan-inflation-targeting.pdf

The ECB's inflation target

➤HICP inflation "below but close to 2%"

➤"over the medium term"

➤"symmetric"

*Mario Draghi on 10 March 2016: "[O]ur mandate is defined as reaching an inflation rate which is close to 2 per cent but below 2 per cent in the medium term, which means that we'll have to define the medium term in a way that **if the inflation rate was for a long time below 2 per cent, it will be above 2 per cent for some time.** The key point is that the Governing Council is symmetric in the definition of the objective of price stability over the medium term.*

Identical with the new FED strategy

Chair Jerome H. Powell

"(...) our new statement indicates that we will seek to achieve inflation that averages 2 percent over time. Therefore, following periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."
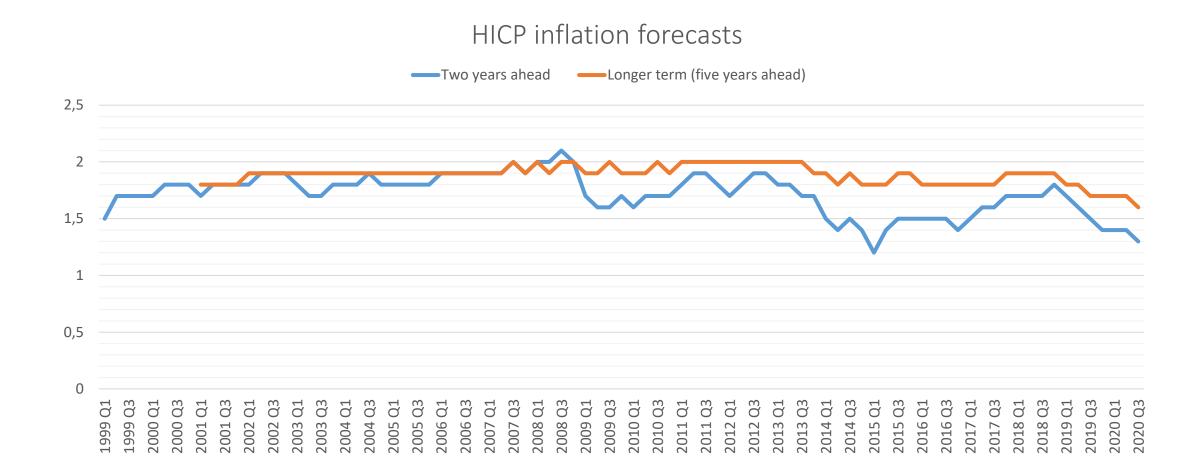
Inflation forecasts?

- Eurosystem and ECB staff produce macroeconomic "projections"

	Date of release	GDP growth			HICP inflation		
		2020	2021	2022	2020	2021	2022
ECB staff projections[1]	September 2020	-8.0	5.0	3.2	0.3	1.0	1.3
Euro Zone Barometer	July/August 2020	-8.2	5.5	1.9	0.4	1.1	1.4
Consensus Economics	July/August 2020	-7.9	5.7	2.2	0.4	1.1	1.3
European Commission	July 2020	-8.7	6.1	-	0.3	1.1	-
Survey of Professional Forecasters	July 2020	-8.3	5.7	2.4	0.4	1.0	1.3
OECD - "Single-hit scenario"	June 2020	-9.1	6.5	-	0.4	0.5	-
OECD - "Double-hit scenario"	June 2020	-11.5	3.5	-	0.4	0.2	-
IMF	June 2020	-10.2	6.0	-	0.2	0.9	-

Source: ECB staff macroeconomic projections for the euro area, September 2020

Inflation forecasts by Survey of Economic Forecasters

HICP inflation forecasts

Source: ECB Survey of Economic Forecasters

Elements of a better strategy

- Forget the two pillars that are nothing but empty shells. Watch closely credit and monetary growth, not as leading indicators for inflation but for financial instability.

- Transform the implicit inflation targeting into an **explicit inflation target**.
  - Clarify the **symmetry** of a medium inflation target.
  - Substitute the awkward "below, but close to 2%" by "2 %"
  - Rename "inflation projection" in "**inflation target**"

- Such a strategy forces ECB critics to make their own concrete inflation forecasts which requires more courage than the popular berating of the ECB, because it can be checked ex-post

A green strategy?

Clemens Fuest @FuestClemens · 16. Okt.
The @ecb should not steer capital flows. Greening monetary policy leads to inefficient capital allocation; it is also a violation of the ecb's mandate and deeply undemocratic.

- Article 127 TFEU: "The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. **Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union** with a view to as laid down in Article 3 of the Treaty on European Union. **contributing to the achievement of the objectives of the Union**

- Article 3 (3) Treaty on European Union: "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on (…) **a high level of protection and improvement of the quality of the environment**."

What can the ECB do?

- For purchases of government bonds the volume must be set according to the overall macroeconomic situation. There is no room for an independent green dimension
- It can privilege „green" companies
  - as collateral for the refinancing of banks
  - in corporate bond purchases
- Climate policy is the main responsibility of national governments and the European Union. ECB can only play a secondary role