An assessment of the recent review of the ECB's monetary policy strategy

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Briefing paper for the European Parliament
29 May 2003

Executive Summary

1. With the revision of the ECB's monetary policy strategy the *role of the money stock M3* as an indicator and/or an intermediate target has been reduced considerably. As a result, the ECB's strategy is now more in line with the mainstream practice of central banking which pays attention to monetary aggregate without assigning a "prominent role" to them. As there is no more direct link between short-term monetary developments and monetary policy decisions, the ECB's strategy will become more transparent than before.
2. A "*broadly based economic analysis*" will now constitute the first pillar of the strategy. The ECB defines this pillar as an enumeration of important economic variables but it leaves it open how they are aggregated in its analyses and forecasts. Accordingly the outcome of this analysis as it has been presented in the ECB's Press Conferences and its Bulletins is rather descriptive and vague. It lacks a clear focus and therefore does not meet the ECB's own requirement according to which a strategy must "convince" the public.
3. It is difficult to understand why the ECB is so much opposed to adopt a strategy based on *inflation forecasts*. They are a natural focal point for any meaningful analysis of monetary policy which could be easily observed and understood by the public. Such a strategy would not imply a "mechanical" response to forecasts and it would not even require that the ECB publishes its own forecasts.
4. The strong appreciation of the Euro shows that the ECB's strategy lacks an *external dimension*. Thus, it is not clear how the ECB should react to excessive developments on foreign exchange markets. The experience of the last few months shows that the ECB has not made use of *sterilised interventions* although this instrument provides an additional degree of freedom which would help to achieve more growth and employment in the Euro area with jeopardising the target of price stability.
5. From 2 January 2003 to 1 May 2003 the *foreign exchange reserves* of the Eurosystem have *declined* by 14.6 € billion (corrected for revaluations). Thus, instead of dampening the decline of the Dollar, the foreign exchange market transactions of the ECB and the National Central Banks have additional strengthened the Euro.

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1. The revision of the ECB's strategy

On 8 May 2003 the ECB has presented a revised version of its "two pillar" monetary policy strategy. It differs from the " "stability-oriented monetary policy strategy", which had been announced on 13 October 1998, in the following points:

- It reduces the role of monetary aggregates in the ECB's analytical framework. The fact that money is no longer given a "prominent role" is underlined by a new ranking of the two pillars where the "monetary analysis" now comes second.
- The former "broadly based assessment of the outlook of price developments" has remained unchanged but it is now presented as a "broadly based economic analysis" and it has been moved to the first rank.
- The interrelationship between the two pillars has been clarified. The economic analysis focuses on short to medium-term risk to price stability. The monetary analysis assesses medium to long-term trends in inflation.
- The quantitative definition of price stability has been made more precise. While the overall target is still to keep the inflation rate "below 2 %", the Council has now added that it aims at rates "close to 2 % over the medium term".

2. A less prominent role for money

The most important change concerns the role of the money stock M3. This is not only related to the formal downgrading of this pillar to the second rank but also to the fact that

- M3 has lost its "prominent role" in the new second pillar, since the "monetary analysis" will focus on a "wide range of monetary indicators, including M3, its components and counterparts, notably credit, and various measures of excess liquidity" (ECB 2003a, p.1),
- the practice of an annual review of the reference value will be abandoned,
- a short-term monitoring of the three-month moving average of annual growth rates of M3 "might be discontinued" (ECB 2003b, p. 16)

With this reduced emphasis on monetary aggregates "as coherent and credible guide for monetary policy" (ECB 1999, p. 48) the ECB has implicitly admitted that the criticisms raised by many economists about its former first pillar were correct. In fact, in my briefing paper for this Committee prepared in March 1999 I wrote:

"Irregular short-term fluctuations of the demand for money make it very difficult to use divergences between the actual money stock and its target as a basis for interest rate policy. Thus, the "reference value" for the growth rate of broad money will in general provide little help for determining a “neutral” monetary policy stance of the ECB on a day-to-day basis.” (Bofinger 1999, p. 14).

This is exactly what has happened. Accordingly the ECB states now: “The medium to long-term focus of the monetary analysis implies that there is no direct link between short-term monetary developments and monetary policy decisions.” (ECB 2003b, p. 18).

As a consequence, the ECB will also have to redesign its Monthly Bulletin, which still starts with an analysis of M3 growth rates and which still presents the *annual* growth rates of M3 in comparison with the 4.5 % medium-term reference value.

There is no doubt this downgrading of the role of monetary aggregates will render the ECB’s strategy more transparent than before. In the last four years and a half most of the signals provided by M3 have been completely misleading – by the way, something which should have been no surprise given the dismal experience of the Bundesbank with almost a quarter of a century of monetary targeting. Thus, in its press conferences and in the Bulletin the ECB will no longer have to start its analysis with an erratic indicator and a lengthy discussion of special factors by which it has been distorted.

3. How informative is the ECB’s strategy?

While the downgrading of the money stock in the ECB’s strategy has to be welcomed, the revised strategy with its two pillars – “economic analysis” and its “monetary analysis” – looks now rather vague. This becomes obvious if one defines the main function of a strategy in the ECB’s own words: It should serve as “an instrument to organise and to convey information to the Governing Council and the public” (ECB 2003b, p. 18). More generally, a strategy can be regarded as a *heuristic* or “rule of thumb” which helps to reduce the enormous complexity of the real world to a small set of relevant information. Thus, an ideal monetary policy strategy should enable an outside observer to check in a relatively simple way whether the current interest rate level is in line with the obligations that the EU Treaty defines for the ECB. This important task has also been emphasised by the ECB:

“A monetary policy strategy must not only signal the overriding objective of monetary policy, but must also convince the public that this objective will be achieved.“ (ECB 1999, p. 44).

As this task is now mainly assigned to the first pillar, one can ask in which way it helps “to organise and to convey information”. If one reads the statements of the ECB, it is difficult to see how the new first pillar will contribute to this important task. As in the past, the ECB defines this pillar by a simple enumeration of a set of indicators that would have to be taken into account by any responsible central bank:

„To this end, the developments analysed include a broad range of information on, for example, wages, commodity prices and exchange rates, asset prices, wealth, external demand, fiscal policy, and domestic financing conditions and costs.“ (ECB 2003b, p. 16).

This lack of a framework for organising and conveying information is also reflected in the texts of the Press Conferences, the Editorial and the Monthly Bulletin. All these publications are of a rather descriptive nature and lack an effort to aggregate the available information in a way that the reader can make his or her own assessment whether the current interest rate level is compatible with the targets stipulated by the Treaty. E.g. in the Editorial concrete data are only used for the actual inflation rate which is of little importance in the context of a forward-looking monetary policy and the information about the future inflation rate could hardly be phrased in a more nebulous way:

"Looking ahead, current indicators do not point to further strong declines in the inflation rate in the immediate future, but lower oil prices, an environment of moderate economic growth, and the effects of the significantly higher exchange rate of the euro should all contribute to reducing inflationary pressure beyond the short term". (ECB 2003c, p. 6).

Thus. under the original and also under the revised strategy the reader can only *believe* that the Governing Council is right if it states, e.g. in the May 2003 Editorial "that the monetary policy stance remains consistent with the preservation of price stability over the medium term" and that it "contributes to a monetary environment that is conducive to economic growth". (ECB 2003c, p. 5).

In sum, while it is certainly not wrong to proclaim a "two pillar strategy" where monetary policy is based on an economic and a monetary analysis, the information content of such a framework is not very high. What else would one expect from a responsible central bank but a careful analysis of economic and monetary data where "no information is lost" (ECB 2003b, p. 17)?

4. The ECB should give a prominent role to inflation forecasts

As a result after the revision of its strategy the ECB's monetary policy will still suffer from a lack of transparency and – in retrospect – also a lack of accountability. As emphasised by many economists and also in my briefing paper from March 1999, the ECB could easily improve its strategy by adopting some form of inflation targeting. It is far from clear why the ECB is so much opposed to this approach. Its argument goes as follows:

"In this respect the argument can be made that a strong focus on a single inflation forecast would not do justice to the complexity of the decision-making process and would also not provide a transparent means to communicate this complexity." (ECB 2003b, p. 17)

This statement can be criticised under two aspects:

- First, the quote shows that the ECB has a rather peculiar view of the rationale of a strategy. As already mentioned. the main function of strategy is to *reduce* in some way the complexity of the decision-making process. Otherwise no "organisation" of information is possible. If a strategy mainly aims at the *communication of complexity*, it would be of little help or even useless since most people are very much aware of this fact of the world.

- Second, there is no need to focus on a *single* inflation forecast. In the past, the ECB already published in every third Bulletin a survey of inflation forecasts produced by international and European institutions (IMF, OECD, EU) and by market participants and research institutions (Consensus Economics and Survey of Professional Forecasters). In addition, the ECB published the break-even inflation rate for 10-year indexed bonds as a market-based inflation forecast. In the more recent Bulletins, the ECB has discontinued to publish forecasts by international institutions and to publish the break-even inflation rate on a monthly basis.

As Table 1 shows, a survey of recent inflation and output forecasts would provide the European public with an objective and forward-looking information of how the ECB will be able to meet its goals in the foreseeable future. With these data as a starting point for the Press Conferences, the Editorial and the analytical part of the Bulletin the ECB could in fact " convince the public" that its objective will be achieved.

Table 1: Forecasts for 2004 (in %)

Institution	Inflation (HICP)	Real GDP growth rate	Output gap
International Monetary Fund (April)	1.5	2.3	-2.4
OECD (April)	1.6	2.4	-1.5
Consensus Economics (May)	1.6	2.0	
Survey of Professional Forecasters (April)	1.7	2.1	

Of course, such an outside assessment could force the ECB to explain its interest rate policy more carefully than before. For instance, in the present situation, the data would immediately raise the question of why the ECB has not yet reduced its interest rates given the fact that all forecasts indicate that in 2004 the inflation rate will be below the 1.7-1.9 % range which Otmar Issing has defined as "close to 2%". Such an explanation would be especially warranted since at the same time a relatively high output gap will persist in 2004.

A comparison of forecasts with the target would be no means imply that monetary policy should "react mechanically to a forecast at a fixed horizon" (ECB 2003b, p. 17). But it would provide a clear framework for a discussion of the ECB's interest rate policy and of the way it tailors its policy to the shocks hitting the economy.

It is important to note that such an exercise would not necessarily require that the ECB presents its own forecasts on a regular basis. For an outside observer it would be already sufficient to know how the ECB's policy is assessed by independent institutions. A publication of the ECB's internal forecast would only be required if it differs considerably from other forecasts.

5. **The strategy lacks an external dimension**

The present strong appreciation of the Euro shows another deficit of the ECB's strategy. When it was designed, its authors seemed to believe that the Euro exchange rate would be more or less determined by macroeconomic fundamentals:

"In the present circumstances – in which there is neither a formal exchange rate agreement nor a general orientation – the euro exchange rate is the outcome of current and expected monetary and other policies in both the euro area and elsewhere, and of the perception of these policies by market participants. As the Eurosystem's monetary policy strategy does not embody an exchange rate target for the euro, the task of focusing on the maintenance of price stability in the euro area is facilitated." (ECB 1999, p. 42)

Thus, the role of exchange rate policy and exchange market intervention was completely neglected in the 1998 strategy. It has also not been addressed in the revision although it has become obvious that monetary or other policies have had very little impact on the Euro exchange. The experience with Euro exchange rate since January 1999 has confirmed the mainstream wisdom that had been already available in 1998.[1]

As a consequence, the European public knows very little about the ECB's exchange rate strategy. This lack of transparency is surprising given the importance that the ECB attaches to the role of transparency and communication in its policy. Above all the strong appreciation of the Euro raises the question of whether the ECB would not have been able to decelerate the process by means of sterilised intervention. This would have reduced the deflationary tendencies from which the German economy is suffering without putting at risk the overall target of price stability.

In my second briefing paper prepared for this Committee in September 1999 ("Options for the exchange rate management of the ECB") I have development a simple framework for sterilised interventions with which it would be possible to limit the Euro appreciation without losing control over short-term interest rates within the euro area. By not making use of this additional degree of freedom, the ECB does not fully comply with the obligations of Article 105 according to which it bears a responsibility for other macroeconomic targets as long as this is compatible with its main target.

Finally, it should be added that in the period from 2 January 2003 to 1 May 2003 the foreign exchange reserves of the Eurosystem have *declined* by 14.6 € billion (corrected for revaluations). Thus, instead of dampening the decline of the Dollar, the foreign exchange market transactions of the ECB and the National Central Banks of the Euro area have additional strengthened the Euro. As detailed information on the composition of the Eurosystem's foreign exchange reserves is not available, a comprehensive assessment of this astonishing finding is not yet possible.

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[1] See for instance Isard (1995, p. 138): "In short, neither the behavioural relationships suggested by theory, nor the information obtained through autoregression, provided a model that could forecast significantly better than a random walk. And furthermore, while the random walk model performed at least as well as other models, it predicted very poorly."

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