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# Monetary Policy and Financial Stability: Are the targets right?

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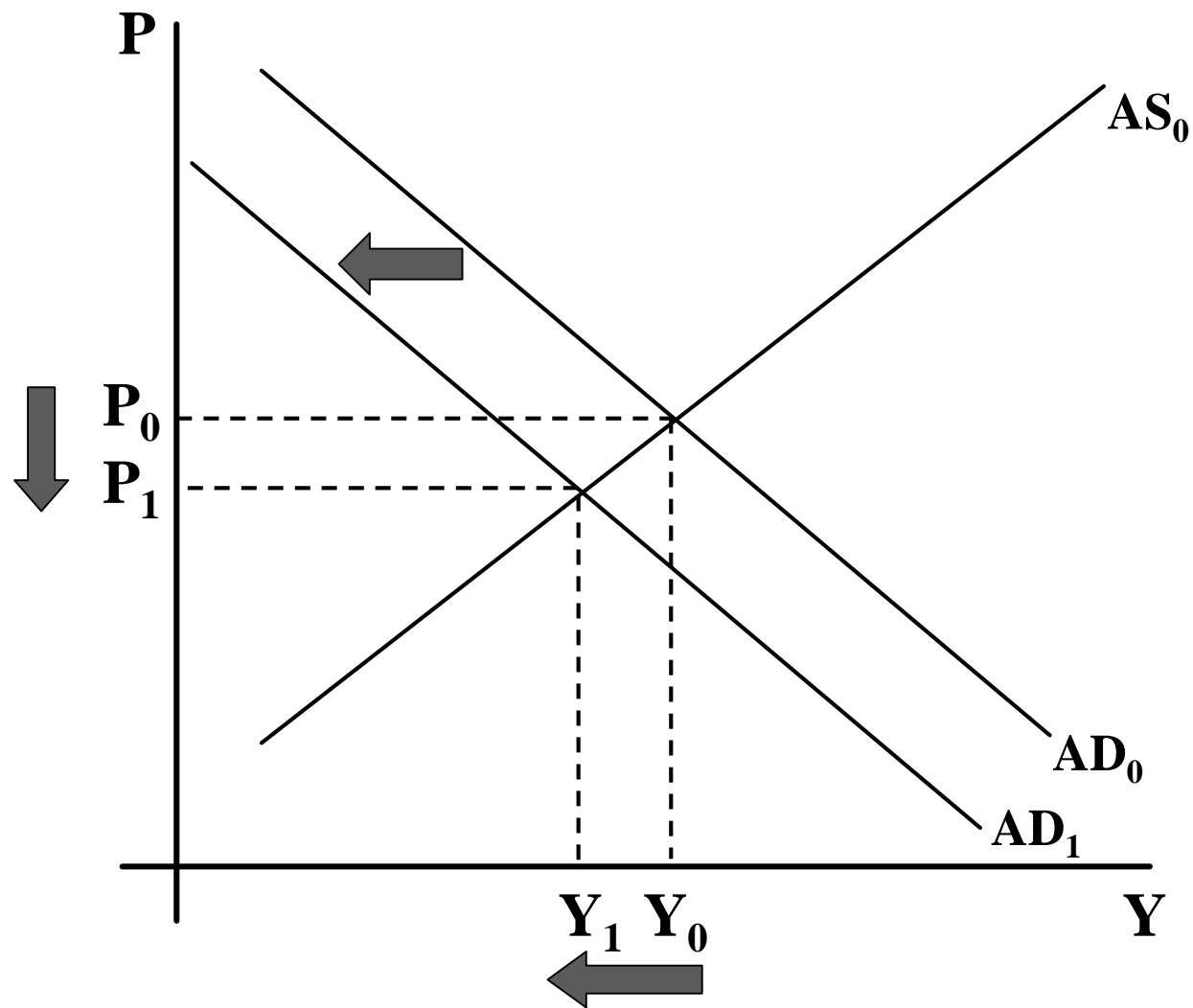
Peter Bofinger  
Universität Würzburg  
Sachverständigenrat

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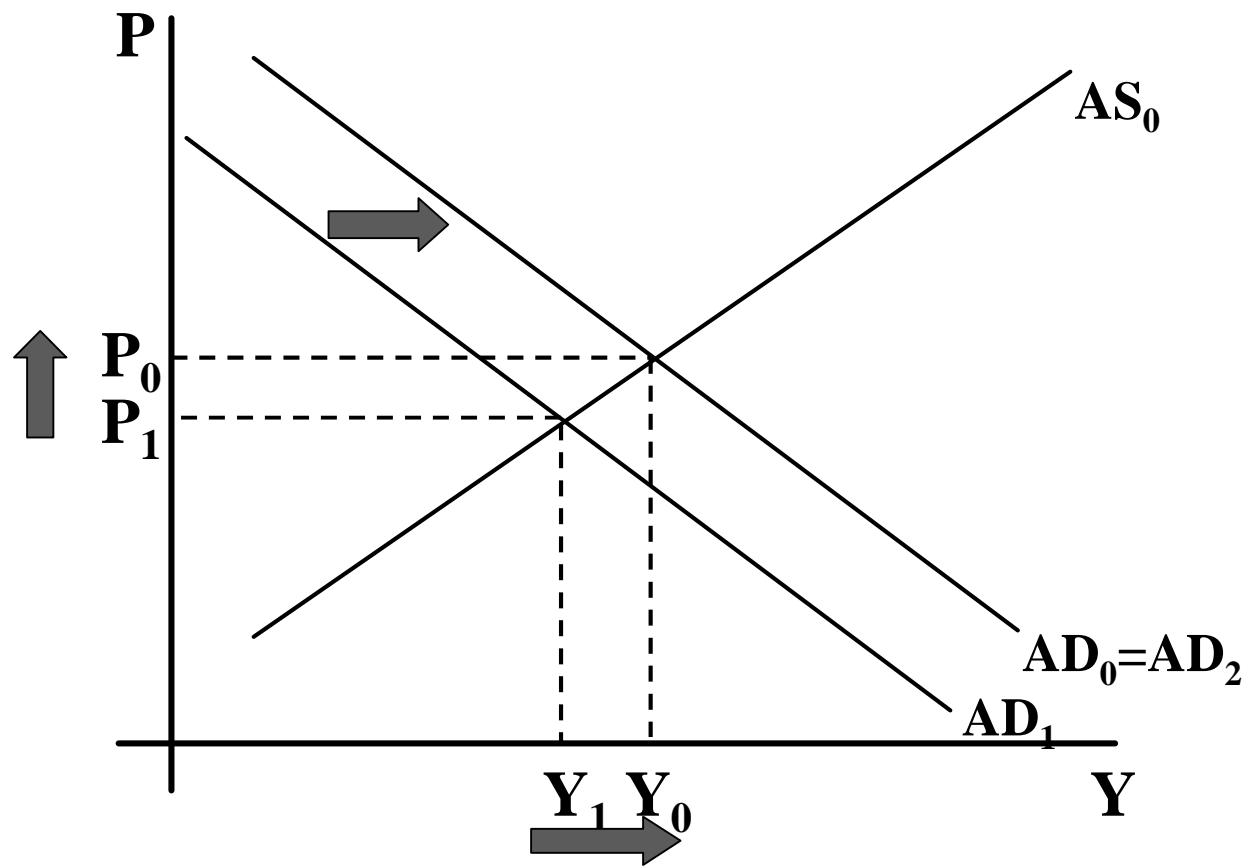
# The ECB's target

- “Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%.
  - Price stability is to ...be maintained over the medium term”.
  - „...the Governing Council further clarified that, within the definition, it aims to maintain inflation rates below but close to 2% over the medium term.“
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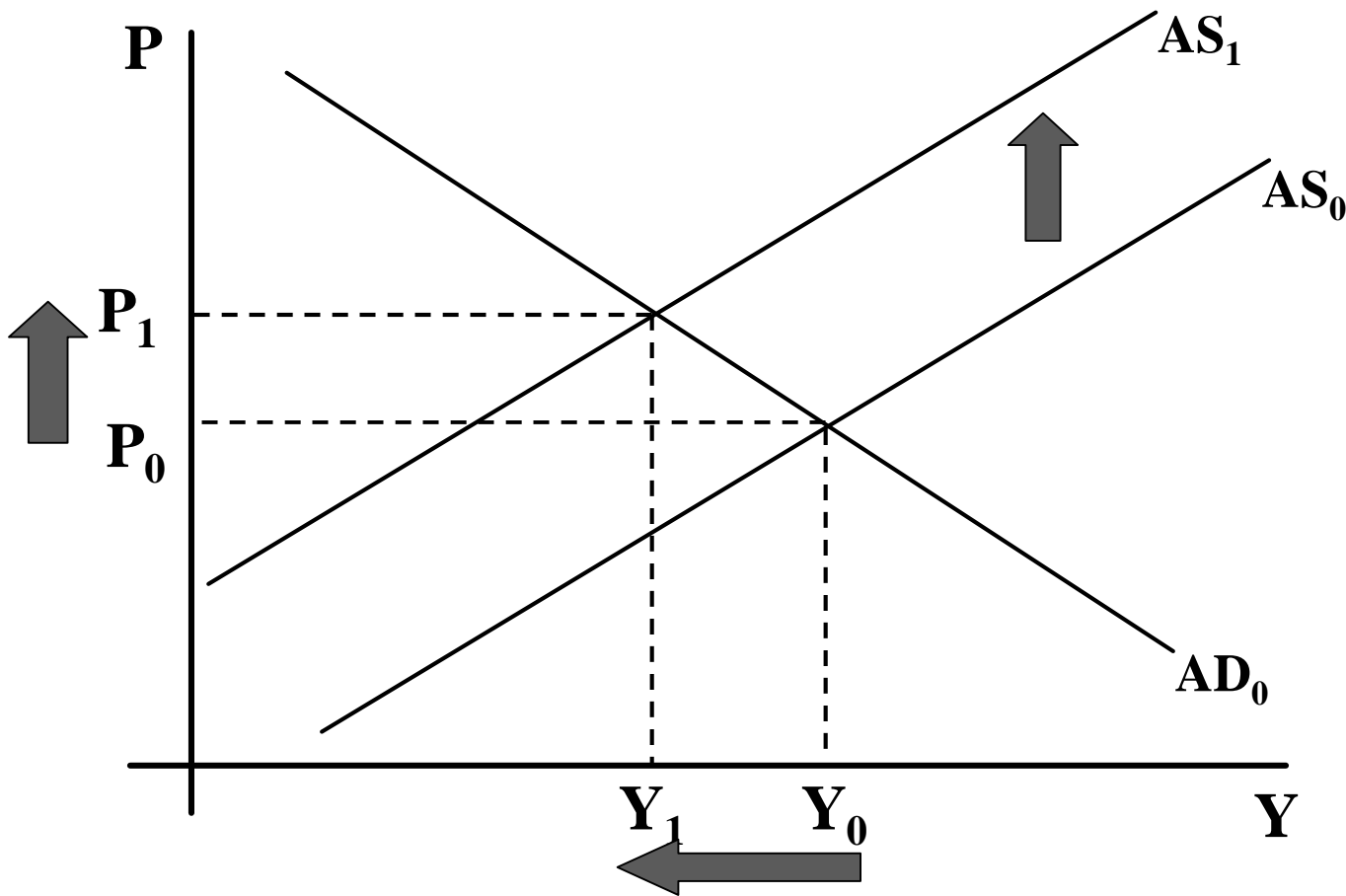
# Demand shock (AS/AD-model)



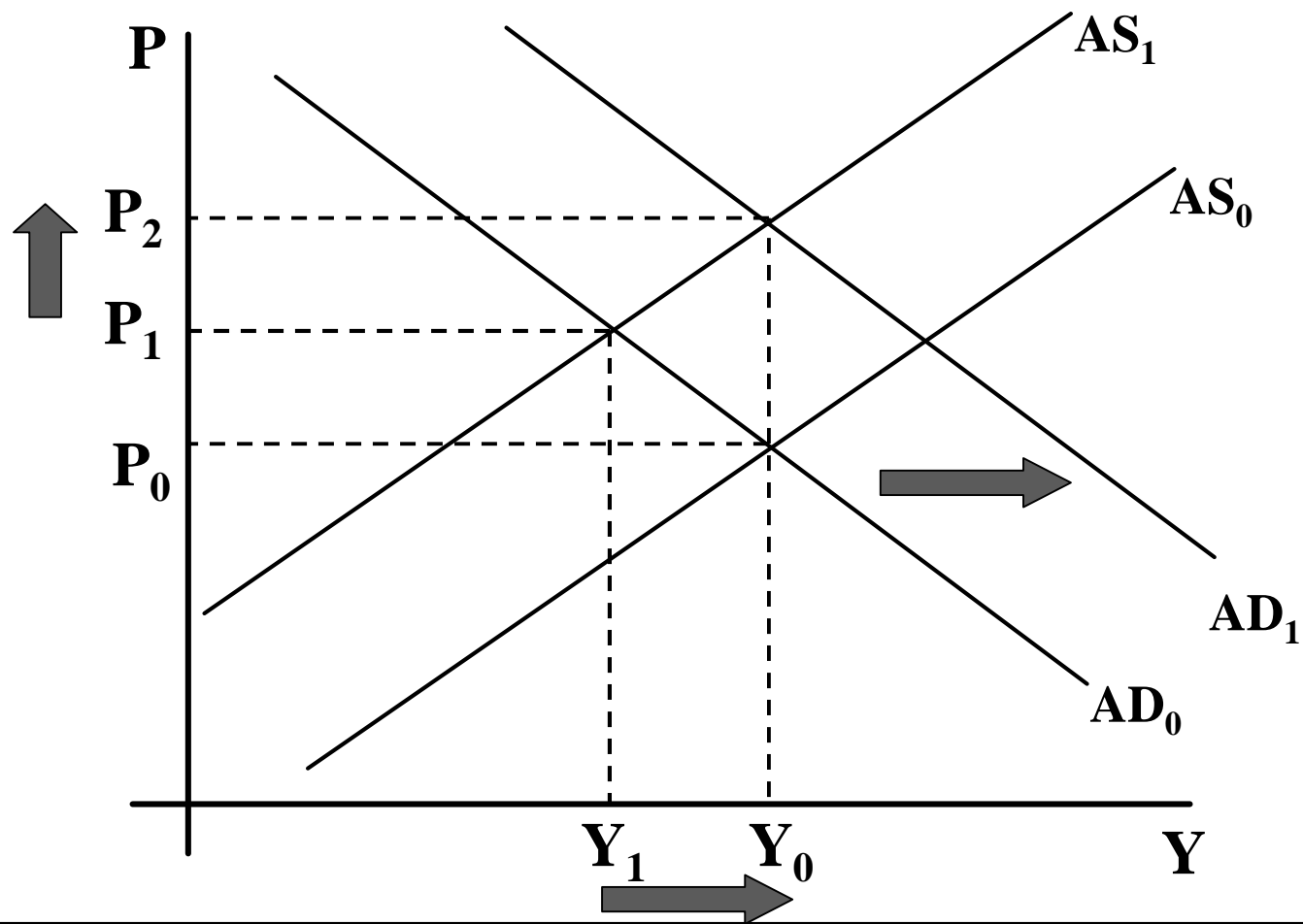
Expansionary monetary policy stabilizes price level **and** output



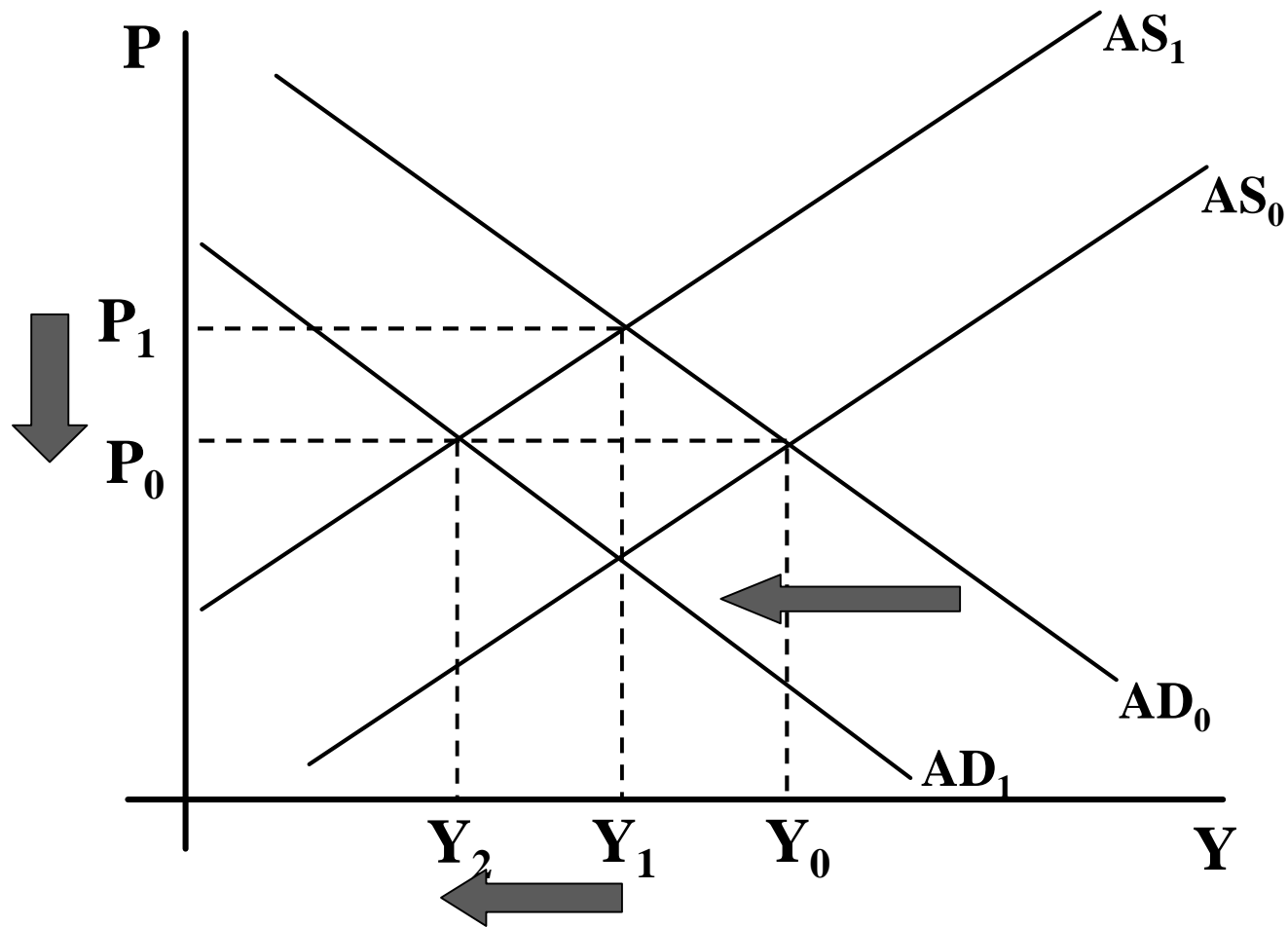
# Supply shock: higher energy prices



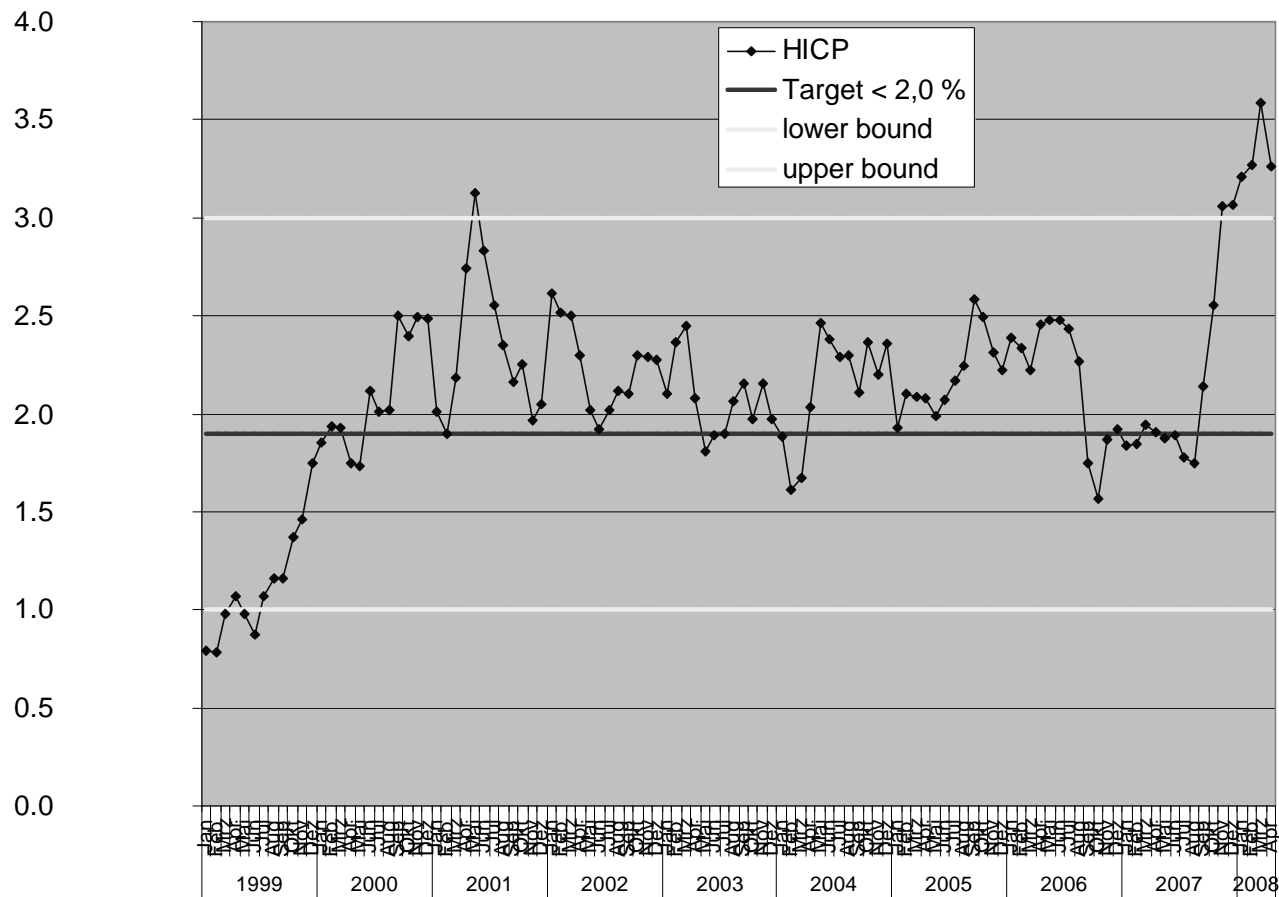
# Output stabilization increases inflation



# Inflation stabilization lowers output



# Below 2 percent: A flawed definition

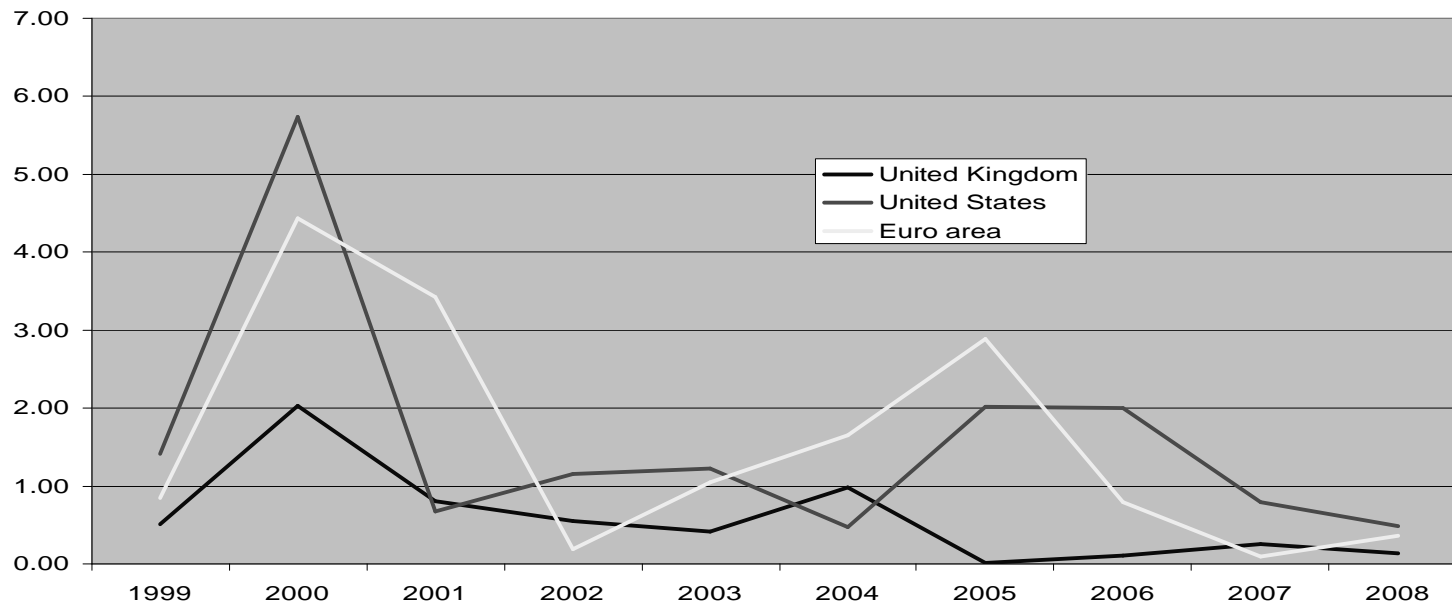




# The ECBs overall performance

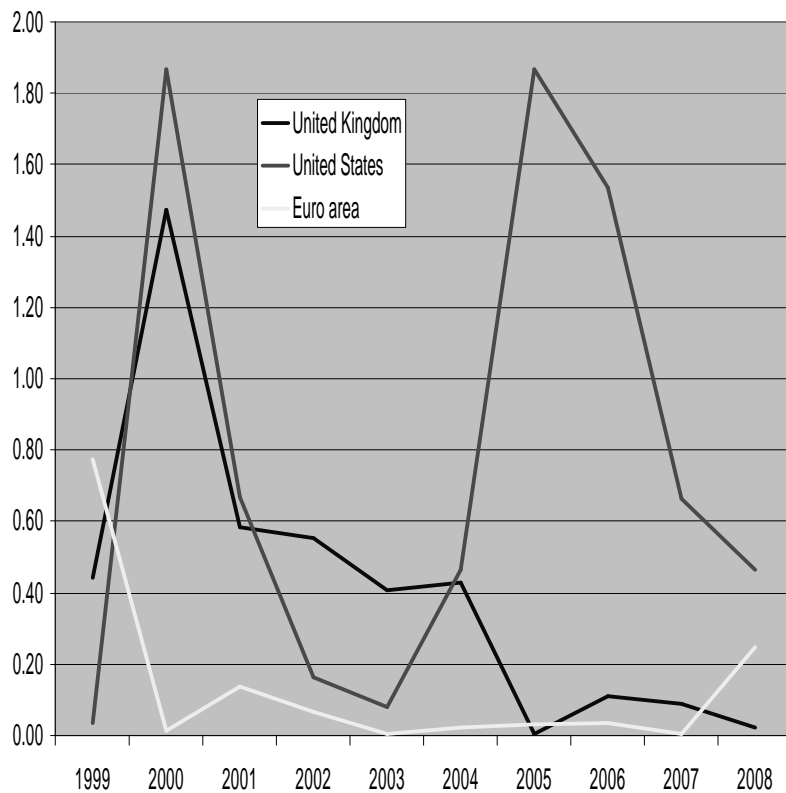
- Loss function

$$L = (p - p^*)^2 + y^2$$

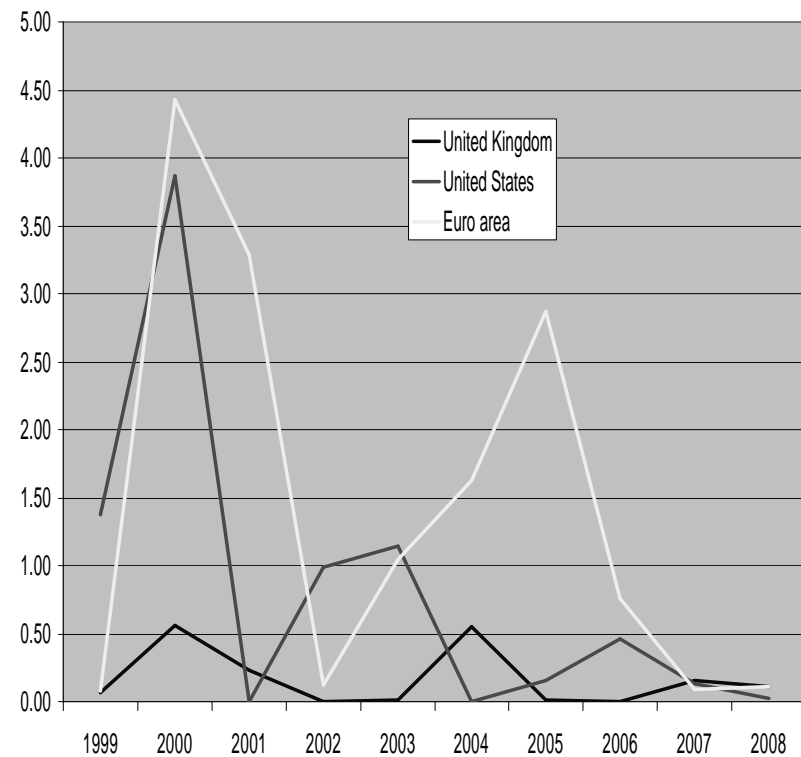


# Dimensions of the social losses

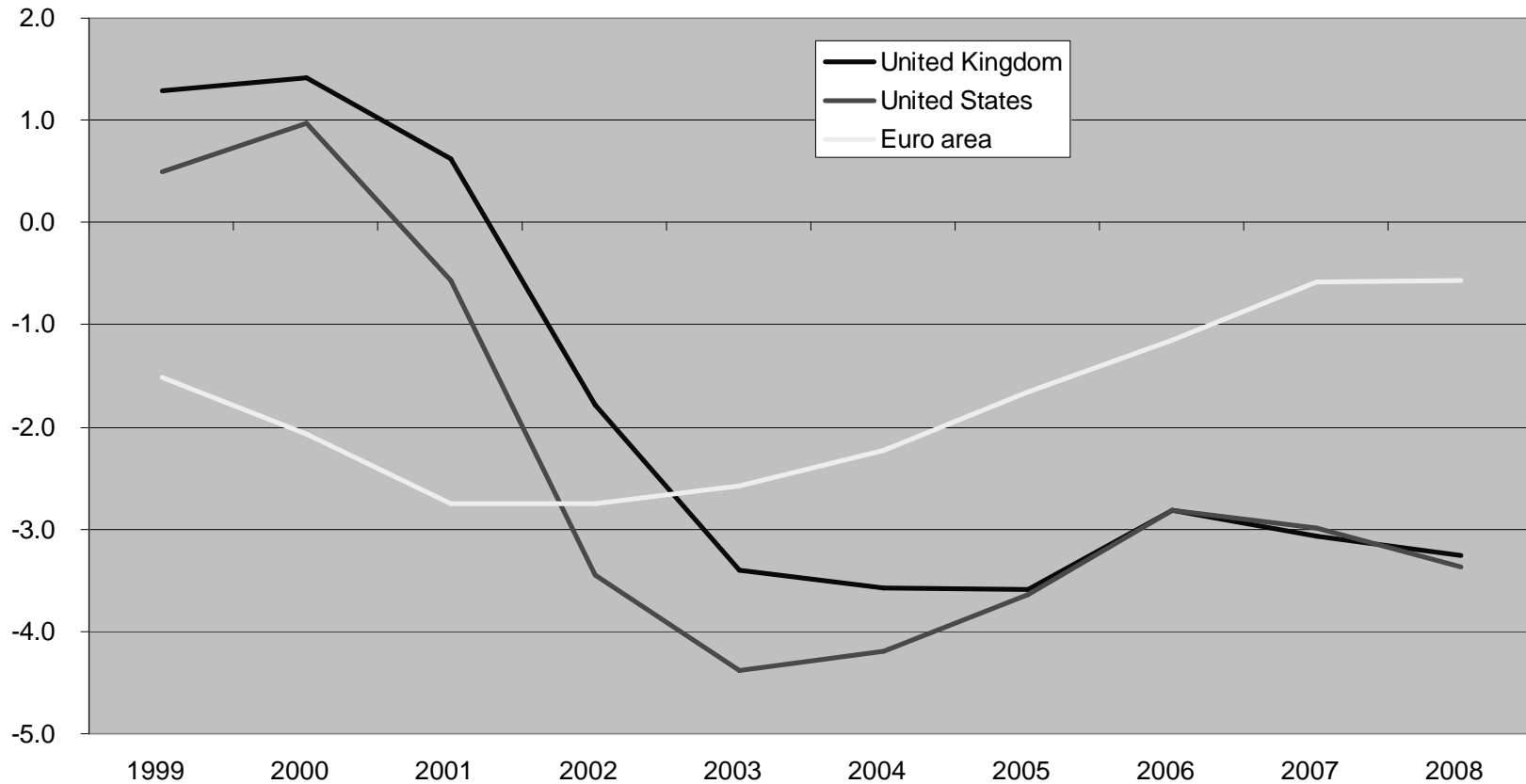
Inflation Loss



Output Loss

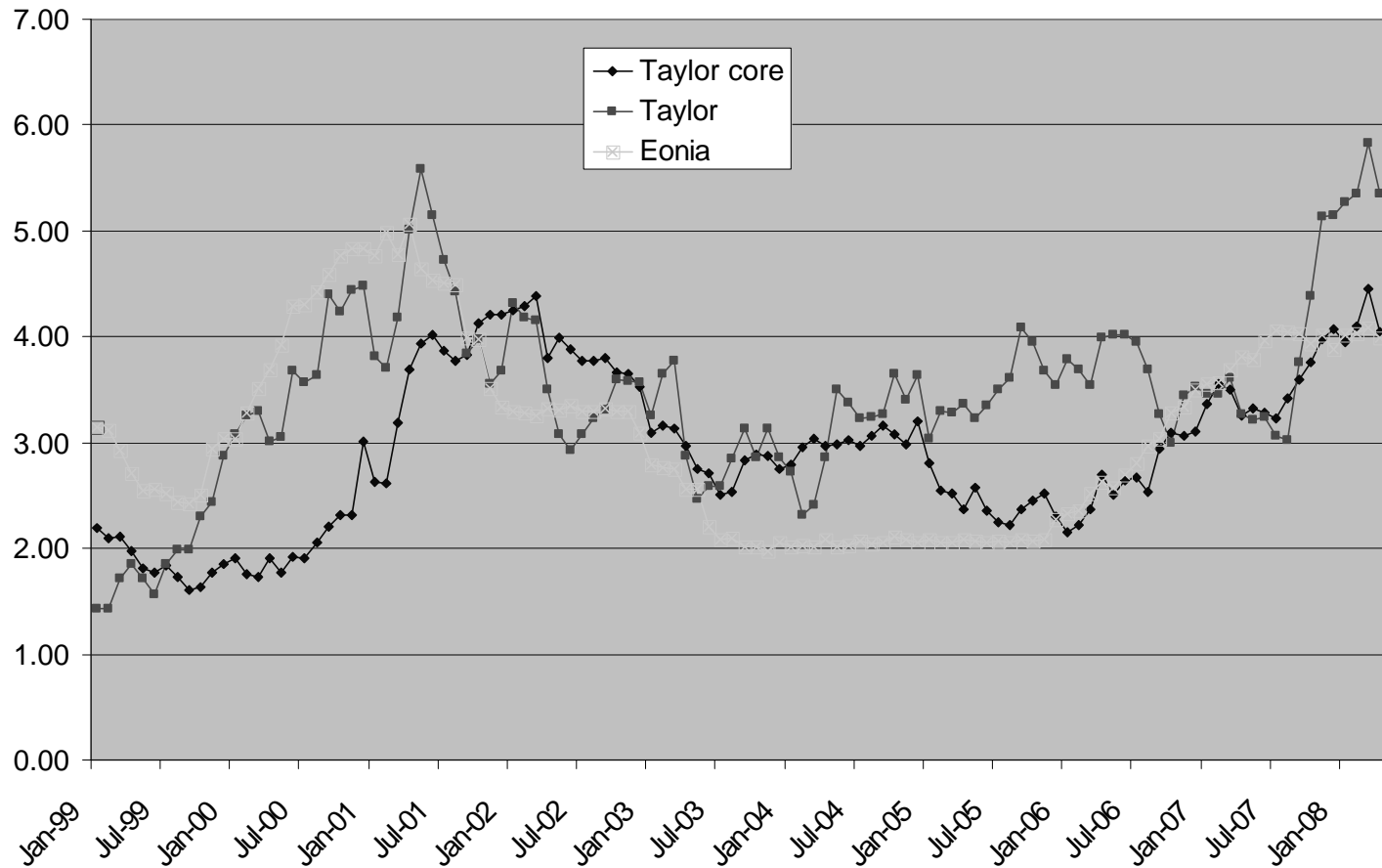


# Euro area: no support by fiscal policy

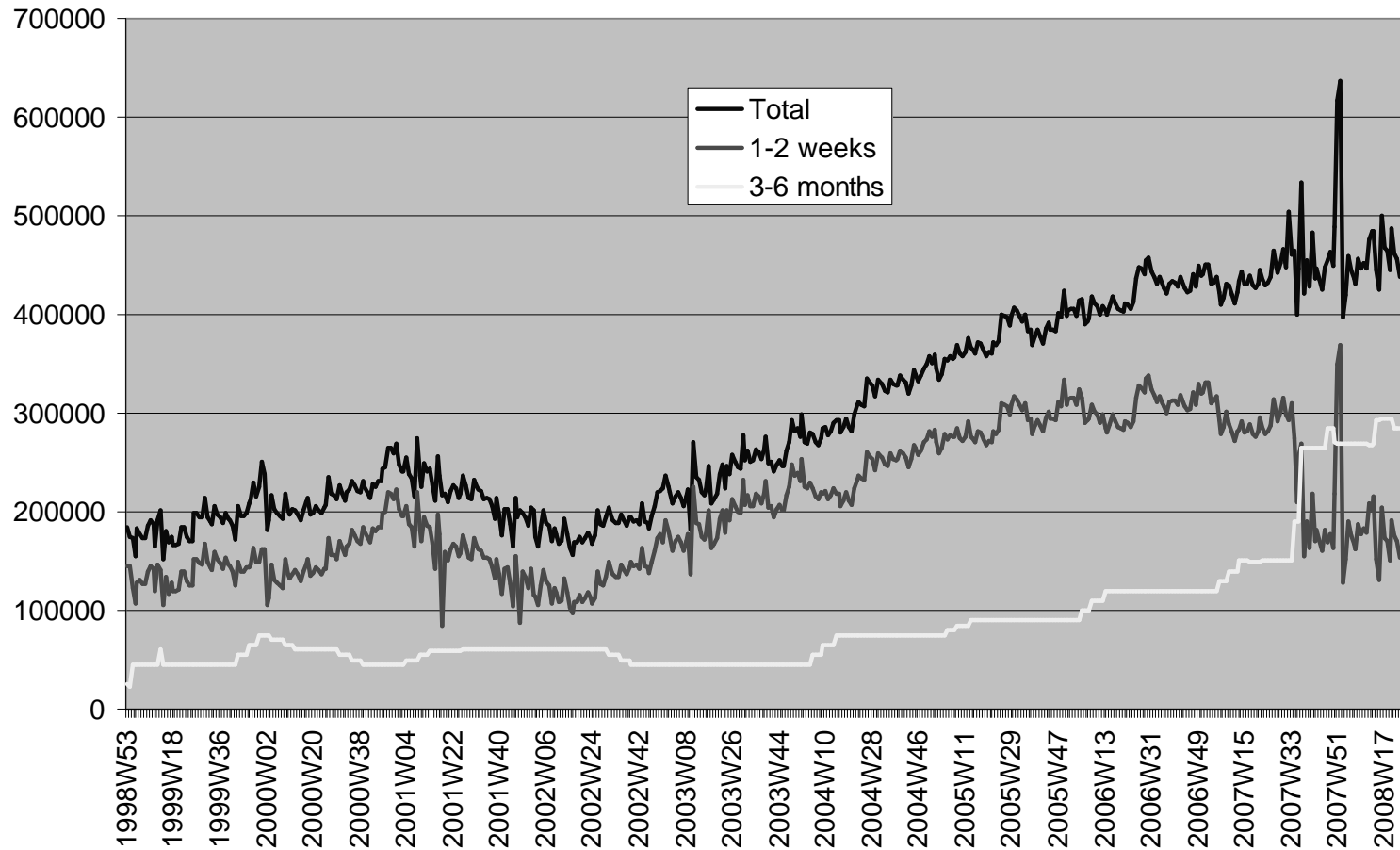


Structural balances in % of GDP

# EONIA and real time Taylor rates



# The ECB's response to the crises

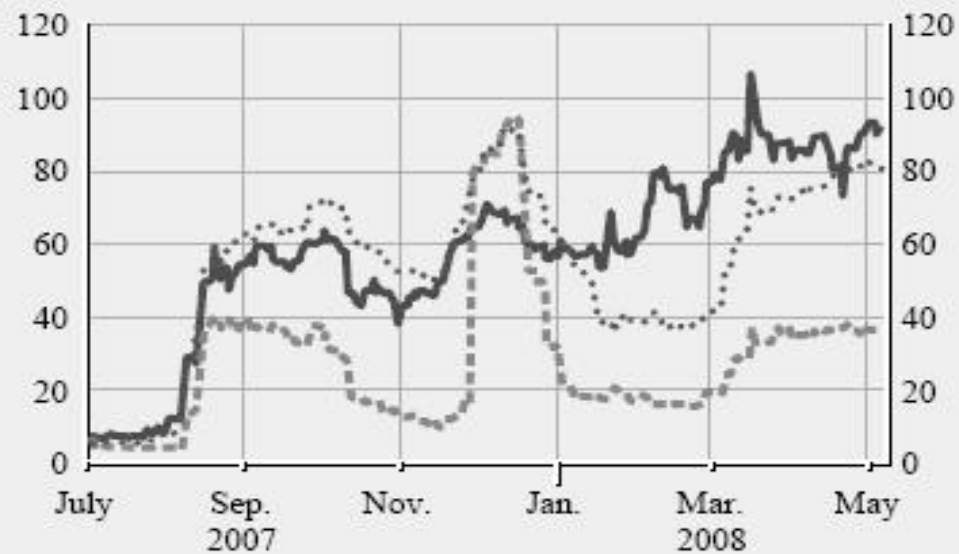


# De facto monetary restriction since July 2007

Chart 3.2 Spreads between EURIBOR and EONIA swap rates

(July 2007 – May 2008; basis points)

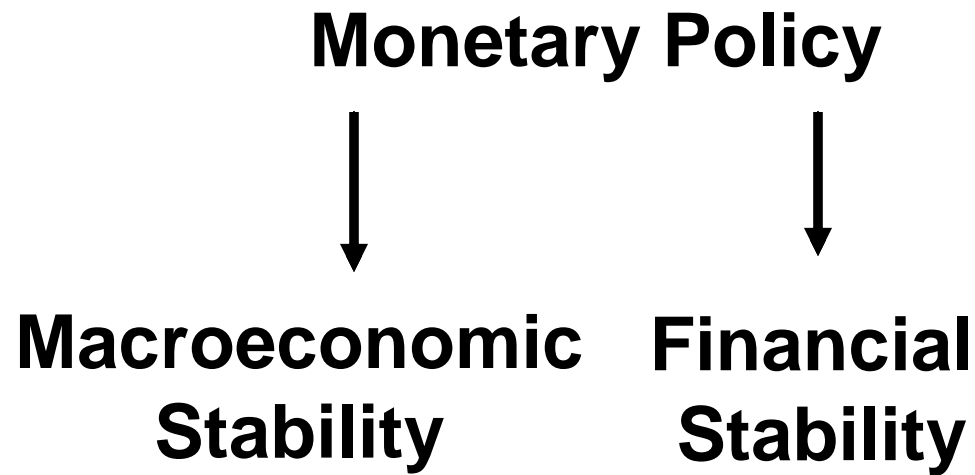
- 12-month
- ..... three-month
- - - - one-month



Source: Bloomberg.

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# The new challenge



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# Summary

- The macroeconomic targets are right, in principle
  - The concrete inflation target should be formulated as a  $\pm 1$  percentage point range around 2.0 %
  - The main problem is a lack of fiscal policy coordination
  - Financial stability has to become a second target of monetary policy
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