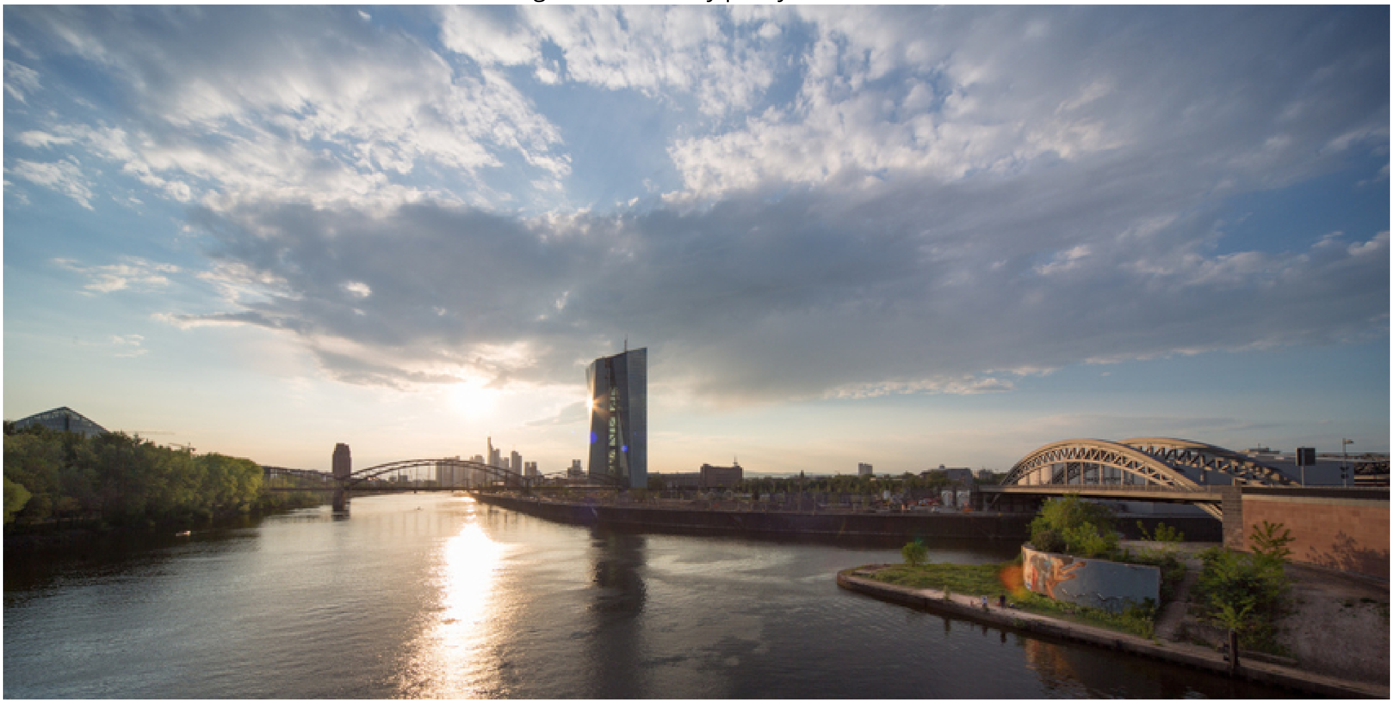
Leibniz Institute for Financial Research SAFE

SAFE Finance Blog

11 DEC 2020

The ECB strategy review – walking a narrow path

Ignazio Angeloni: The European Central Bank must deliver but not send the wrong signals. Overly ambitious inflation targets must be reconsidered, as must hardened strategies in monetary policy



Expectations are mounting for the outcome of the ECB monetary policy strategy review. An academic panel hosted by the ECB online on 11 November focused on the real crux of the matter: the poor understanding of inflation, a variable the ECB mandate hinges on but which has become more and more difficult to explain and control. For several years now, inflation has remained below the central bank's target of "close to but below two percent".

A recollection of the precedents helps put this in context. In 1998, its inaugural year, the newly established ECB announced a strategy to explain how it would attain its price stability mandate. The goal was expressed as an inflation rate below 2%. This definition was based mainly in terms of its continuity; it was, after all, consistent with established practices all over Europe. This reveals that that particular number, and the word "below" which preceded it, were inherited from a world in which the predominant concern was keeping inflation low, and the eventuality of deflation was not seriously considered.

Undesirable consequences of inflation policy

In the euro's early years inflationary pressures prevailed, albeit muted ones. In 2003, the ECB clarified that the target was intended to be "close to" two percent, as opposed to anywhere "below" that level. Several arguments were presented, but the trigger of that change was essentially contingent: energy and food prices tended at that time to push measured inflation up. The ECB regarded them as relative price changes, which monetary policy should accommodate. That judgement turned out to be correct: those same prices subsequently moved inflation in the opposite direction. Yet the revision, and the fact that the "below" was kept, had two undesirable consequences: it restricted the admissible range and aggravated the perceived asymmetry of the ECB policy. It contributed to validate an image of the ECB as an inflation buster, rather than as a central bank that tries to limit deviations of inflation from the desired level equally in either direction.

The problem became more apparent after the financial and the euro crises (2009-2011). For most of the ensuing ten years, euro area inflation stayed below – recently, much below – the reference level. Successive waves of monetary expansion have not succeeded to bring it up. Though there is no counterfactual, one cannot exclude that the ECB's attempts to reinflate the economy may have been frustrated by that perception. In 2020 Covid and the related collapse of energy prices accentuated the unpleasant mix of yet lower inflation and more monetary expansion.

Two interpretations of the ECB's course

Two interpretations exist, each with a distinct policy recipe. One calls for ever more monetary accommodation, counting that the goal will be reached eventually, and suggest the central bank should signal its resolve by raising the inflation target. The other purports that monetary expansion has lost power, mainly due to changes in price dynamics at global level, and its negative side effects have grown. This view calls for rebalancing the stance and is supported by the fact that measured euro area inflation is recently driven by imported prices, whereas the domestic components of inflation have moved up. The two arguments make for an interesting debate. Unfortunately, the ECB needs to decide before it is settled.

The review offers an overdue opportunity to remove the undesired asymmetry of the ECB monetary policy. To that aim, the word "below" needs to disappear and be replaced by a focal reference, accompanied by a suitable symmetric tolerance margin. Here, however, the easy part ends and the hard one begins. The ECB walks a narrow path with dangers on both sides. On the one hand, it should not signal a tightening of policy, which would be inappropriate under plausible scenarios. On the other, it may not desire to tie its hands in the opposite direction either, by committing to ambitious inflation targets it may find hard to achieve. This risk would also exist if it adopted the type of "average inflation targeting", recently announced by the Fed, which contains an implicit promise to lift inflation above target in the future. Commitments or promises of such kind would be hard to believe and even if they were believed at first, would entail considerable risks to reputation going forward.

To be effective and durable, a central bank monetary strategy should be stance-neutral and cycle-blind. It must be a framework for making and explaining decisions, without preempting them, valid beyond current contingencies and the present stage of the economic cycle. The combination of focal point and tolerance margins announced by the ECB, while surely excluding negative inflation, may well allow for low positive inflation levels, if sustainable, of the kind experienced in recent years. A central target of 2% surrounded by a tolerance margin of plus or minus 1% would, for example, would do.

The ECB is extending its priorities

That said, the review should not be limited to adjusting the inflation targeting framework. Two areas, overlooked in both the original strategy and the 2003 review, have become more important in recent years: the identification of policy goals and the cooperation with other policy-makers – most notably the executive branches. Related but distinct, the two areas have gained importance due to new societal priorities emerged in recent years, to which central banks are called to contribute. For example, the ECB has recently indicated a possible involvement in combating climate change. By the same logic, fighting pandemics could in principle be another area of involvement.

The ECB has traditionally taken the view that, when monetary policy is concerned, cooperation with governments would put its independence at risk. It also argued that other policy objectives, which are in fact foreseen by the EU Treaty but are subordinated to the maintenance of price stability, are best served by the central bank concentrating only on its primary goal. Three changes since then suggest a reconsideration. First, 20 years of performance have strengthened the ECB's reputation and confirmed its independence. Second, the ECB has recently acquired responsibility for bank supervision and financial stability, areas more closely connected with a broader range of societal concerns. Thirdly, the nature of the challenges has evolved, requiring the central bank to occasionally complement policies undertaken by the EU. The actions undertaken in the Union to counter the Corona crisis are the most recent example.

Cooperation with the EU executive, on the condition that such cooperation is not mandated but autonomously determined by the central bank itself in the pursuit of its own mandate, should not constitute a threat to independence. On the contrary, reluctance to cooperate under major crises may reinforce opposition to central bank independence. In order to remain within the right perimeter, however, certain safeguards may be needed. It is up to the central bank to define the appropriate cooperation framework, as part of its strategy. In this context, the admissibility of "secondary" objectives and the modalities and limits of their pursuit by the central bank could naturally be framed.

This article was originally published on VoxEu.

Ignazio Angeloni is Senior Fellow of the Harvard Kennedy School and the SAFE Policy Center.

BACK

NEWS & LATEST

In this Section:

Leibniz Institute for
Financial Research SAFE

Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Phone: +49 69 798 30080
Fax: +49 69 798 30077
Email: info@safe-frankfurt.de