Evaluation of the ECB's monetary policy strategy

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1. 1998: Strategy for a new currency

Main elements:

- **Quantification of the primary objective provided by the Treaty**

  ➔ Definition of price stability

- **Two key elements (“pillars”) supporting policy decisions aimed at price stability**

  ➔ “Prominent role for money”

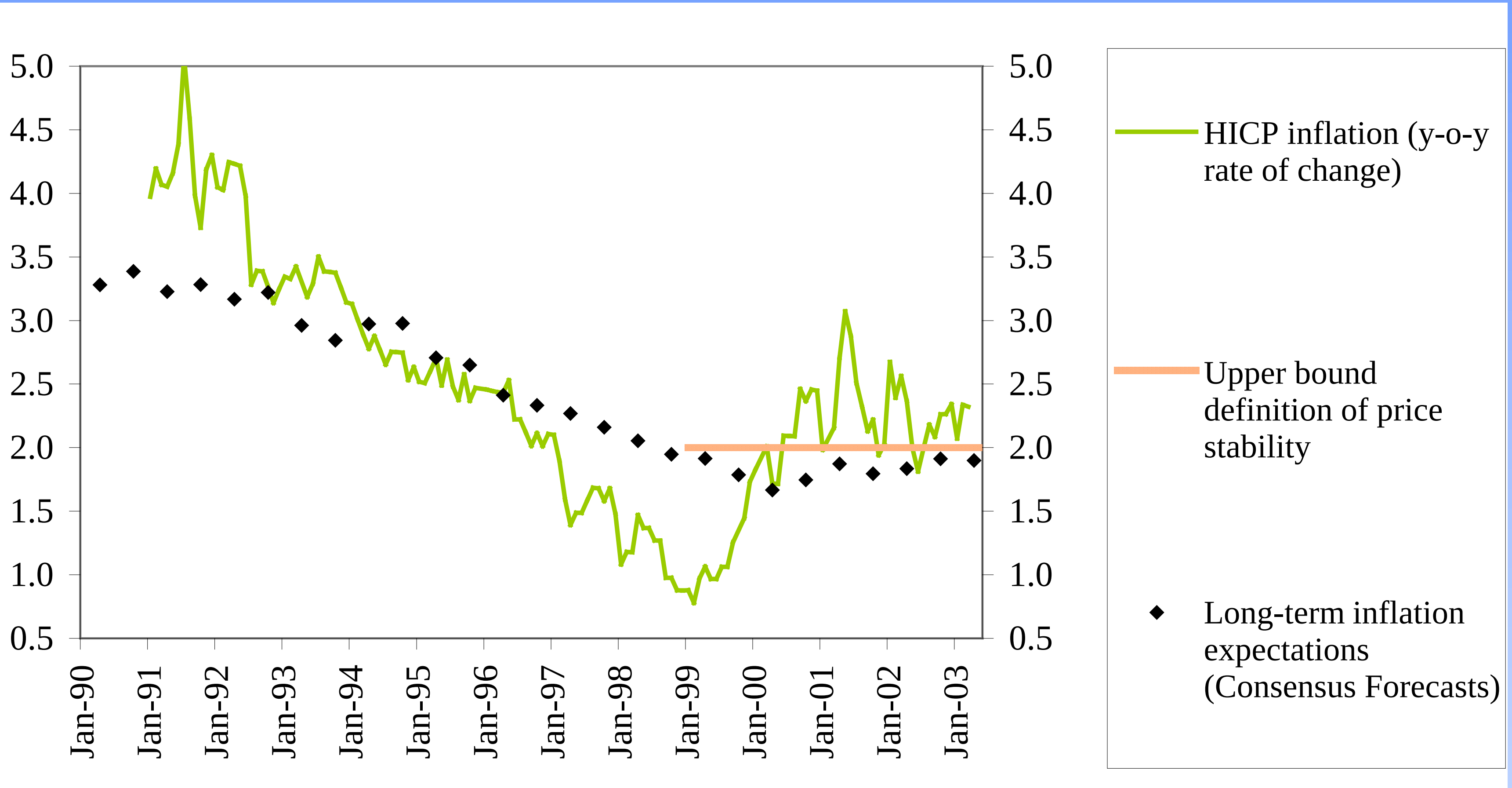
  ➔ “Broadly based assessment of the outlook for future price developments”

2. Positive experience with the ECB's monetary policy strategy

- Explicit quantification of primary objective
- Medium-term orientation of policy (no fixed horizon for the objective; no activist fine-tuning; gradual response)
- Monitoring monetary aggregates
- Projections are important, but not all-encompassing
- Robustness (using different approaches, models and forecasts)

➔ **low and stable inflation expectations despite major upside price shocks**

Euro area inflation expectations since 1990 (*Consensus Forecasts*)



3. Rationale for the evaluation

Useful to take stock of ...

- four and a half years of experience with the strategy
- comments from academics, analysts, journalists
- results from a series of internal studies

4. Main results of the evaluation

- **The quantitative definition of price stability**
- **The role of money / two-pillar approach**

➔ **Clarification of communication**

5. The quantitative definition of price stability

The Governing Council agreed

- ➔ **Definition of price stability is confirmed**
- ➔ **"… aim to maintain inflation rates close to 2% over the medium term"**

… taking into account

- <u>Costs of inflation</u>
- Need for sufficient <u>safety margin</u> to guard against <u>risks of deflation</u> (also covers a possible <u>measurement bias</u> in the HICP and implications of <u>inflation differentials</u> within euro area)

6. The two-pillar approach

Rationale for the two pillar structure

– Different time perspectives

Economic analysis ➔ focus on shorter-term price movements
Monetary analysis ➔ focus on longer-term price trends

– Organisation of information

Monetary phenomena are not fully captured in conventional macroeconomic analysis/forecasting models

➔ **Monetary analysis as a means of cross-checking, from a longer-term perspective, the shorter term indications from economic analysis**

➔ **Robustness across analytical approaches**

➔ **Based on all information Council comes to a single assessment**

7. Economic analysis

Broad range of economic/financial developments are analysed, to assess economic shocks, dynamics and perspectives and the resulting risks to price stability over the short to medium term

Projections are important, but

- have limitations
- do not exhaust the economic analysis

8. Monetary analysis

- No evidence that long-run link between money and prices has broken down in euro area; many studies show good leading indicator properties
- Excess money/credit may provide additional information for identifying financial imbalances and/or asset price bubbles, which ultimately may impact on price developments

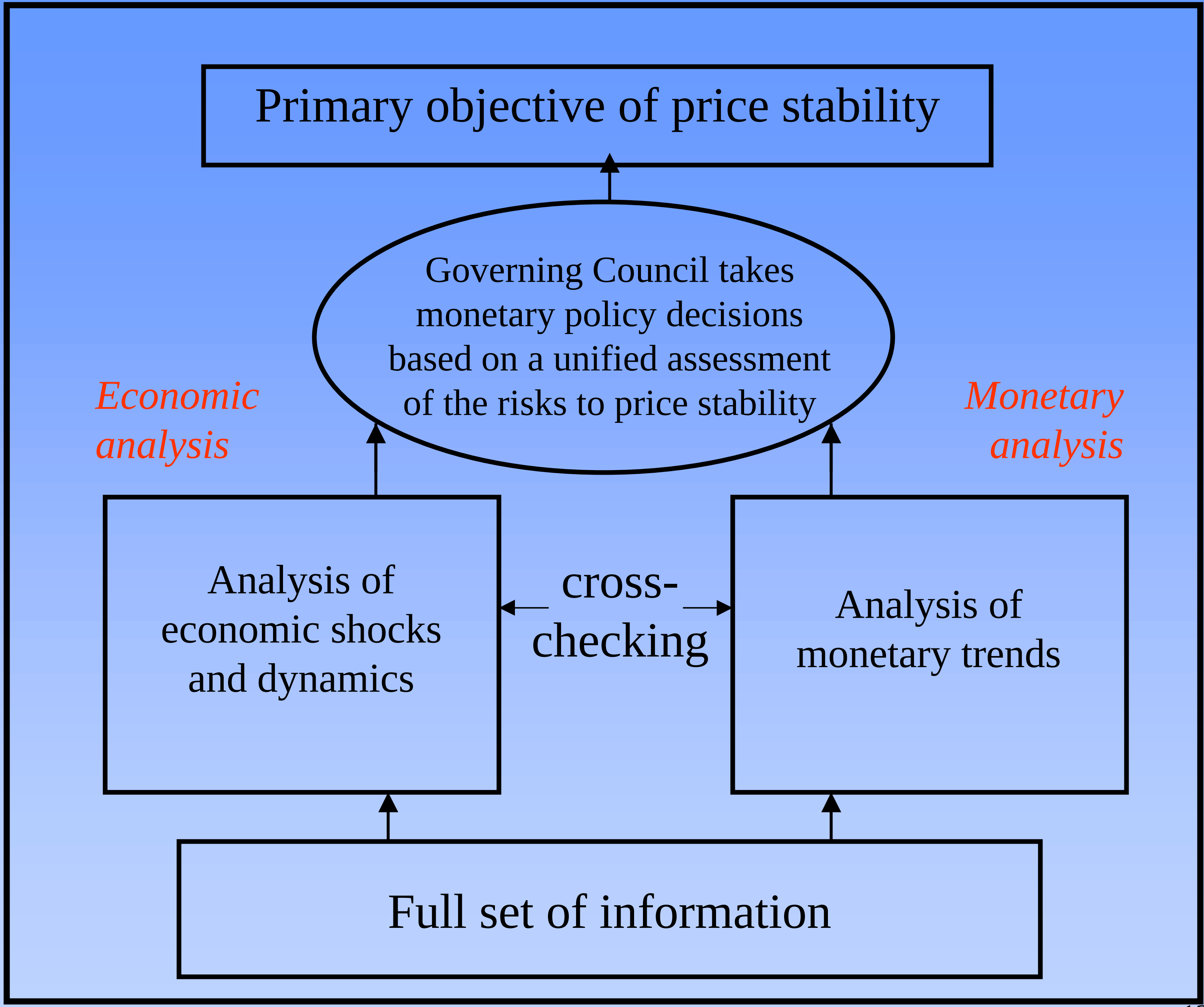
➔ Money as medium to long-term benchmark: cross-check for longer-term evaluation of monetary stance

9. Economic and monetary analyses

… have been deepened and extended over time:

- **economic analysis**: further developments in <u>structural models</u> to assess state of the economy, tools and <u>models for forecasting</u>, assessment of implications of <u>financial and asset price developments</u> for real dynamics and inflation prospects

- **monetary analysis**: goes beyond the M3 deviations from the reference value; includes many <u>narrow/broad money</u> and <u>credit</u> aggregates; <u>money gap measures</u>; <u>smaller models to assess monetary developments,</u> etc.



Primary objective of price stability
Governing Council takes monetary policy decisions based on a unified assessment of the risks to price stability
Economic analysis
Monetary analysis
Analysis of economic shocks and dynamics
cross-checking
Analysis of monetary trends
Full set of information

Annex

The welfare costs of inflation

- Distortions in relative prices (nominal wage/price rigidities)
- Distortions related to non-indexed tax systems
- Reduced consumer surplus from real balances (inflation tax)
- Costs resulting from inflation/deflation uncertainty (risk premia in interest rates; hedging; arbitrary redistribution of wealth)

➔ **Widespread consensus: even low inflation entails significant costs**

The reasons for a safety margin above zero inflation

a) Measurement bias in the HICP

b) Downward nominal rigidities in wages

c) Inflation differentials within the euro area

d) Zero lower bound on nominal interest rates/deflation risk

➔ **The safety margin is sufficient to avoid any major risks of deflation. At the same time, it addresses the other factors listed above.**

… a safety margin above zero inflation: a) HICP measurement bias

- More recent evidence suggests: bias is probably very small
- Continuing effort by Eurostat to improve the HICP (co-operation with ECB)

… a safety margin above zero inflation: b) downward nominal rigidities

- relevance is limited:
  - flexible wage components
  - positive trend productivity growth
  - rigidities are endogenous: likely decrease in a regime of sustained price stability and with structural reforms
- not clear that monetary policy should accommodate such rigidities

… a safety margin above zero inflation: c) inflation differentials

- Argument relates to <u>Balassa-Samuelson</u> effect in combination with <u>downward nominal rigidities</u> in “low-inflation” countries. Size of this effect seems rather small, even after enlargement.

- <u>*Regional* deflationary spiral</u> extremely unlikely as long as there is no deflationary spiral in the area as a whole.

… a safety margin above zero inflation: d) zero lower bound on nominal interest rates and the risk of persistent deflation

- Studies show probability of zero bound being reached is rather small when the inflation objective is above 1%
- Studies arguing for higher safety margin often based on restrictive assumptions (e.g. simple policy rules; 2% real equilibrium rate)
- Overall, large uncertainty regarding probability of binding zero bound

Inflation expectations in the euro area since 1999