

BRIEFING NOTES TO THE COMMITTEE FOR ECONOMIC AND MONETARY AFFAIRS OF THE EUROPEAN PARLIAMENT

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THE STRATEGY REVIEW

Executive Summary

The strategy review represents a step in the right direction, but only a step. The positive aspects include the adoption of a more realistic definition of price stability and the practical removal of the reference value for M3 growth.

The review process, conducted entirely internally and in total secrecy, is a *fait accompli*. It is to be deplored that the ECB has not seen the need to submit the process to democratic accountability and to professional scrutiny.

The price index remains the Harmonized Index of Consumption Prices (HICP). There is no compelling reason to adopt core inflation.

The new definition of price stability, “about 2%”, is more realistic than the previous 0-2% range. Yet, it is more imprecise than the previous one, as it does not specify any tolerance margin. It further fails to be specific about what constitutes the “medium run”.

This approach also represents a step backward as it further rejects the notion that the ECB has an inflation target. No central bank with a price stability objective can operate without some inflation target. The new posture hurts both the bank’s transparency and its ability to anchor expectations, a key requirement for policy effectiveness.

The ECB remains silent on its secondary objective, supporting the activity level.

The removal of the reference value for M3 growth is a welcome acknowledgement of the poor link, at the policy horizon, between money growth and inflation. The preservation of the two pillars, however renamed, is a disappointment.

The two pillars are meant to be used as a “cross checking” of an analysis which cannot but aim at forming a view of future inflation and growth. The two pillars will continue to be used to avoid recognizing the inevitably central role of forecasts.

The two pillars will also lead to a continuation of the unsatisfactory, ritualised communication strategy.

1. General Assessment

Quite unexpectedly, the ECB announced earlier this year that it would be conducting an internal review of its monetary policy strategy. The original announcement did not specify a precise release date nor did it provide any detail on the review process. The results were unexpectedly announced on May 8. As befits any major central bank, the initial strategy has been subject of extensive scrutiny and criticism ever since it was announced in October 1998. As noted in several of my earlier Briefing Notes, a fair assessment is that the strategy implementation has worked well in the sense that the policy decisions have been generally right and reasonably well timed, but the formulation of the strategy has prevented effective communication and transparency. The review was therefore highly welcomed and, while the ECB was prompt to diffuse expectations of major changes, it was hoped that the most generally recognized shortcomings would be dealt with.¹

The review undoubtedly represents a step forward. The definition of price stability has been raised, the reference value for the money (M3) growth has been discarded and money growth no longer serves as the first prominent pillar. At the same time, the definition of the inflation objective remains imprecise, the new strategy still relies on two relabelled pillars, which implies a continuation of the rigid communication that has been the ECB's much deplored hallmark.

2. The Procedure

The strategy review has been entirely conducted internally. Upon announcing its conclusions, the ECB has released 10 papers prepared by the staff, six on the definition of price stability, four on the two pillars. No outside expert seems to have been asked to contribute a paper, or evaluate the internal work, or comment on the conclusions. Similarly, while endowed with the authority to supervise the ECB, the European Parliament does not seem to have consulted.

This procedure is highly questionable on both democratic accountability and professional expertise grounds. The ECB often expresses the view that its strategy cannot be frequently changed for fear of appearing rudderless. This argument – of limited value – implies that, once set, the strategy cannot be changed for an extended period of time. This, in turn, implies that the ECB should make clear efforts to ensure that the democratic representation approves of the strategy and that the strategy is technically sound. Quite the opposite has happened, for the second time. The

¹ See my Briefing Note for the First Quarter of 2003, in particular the conclusion:

“In announcing its strategy review, the Eurosystem has insisted that there should be no presumption that the intention is to change anything. It makes sense to attempt to deter expectations of radical changes but it would be unfortunate to maintain the *status quo*. For questions of prestige¹, the Eurosystem may well reject IT. Yet, some changes are absolutely required:

- Abandoning the two-pillar strategy.
- Raising and possibly widening the inflation target range.
- Publishing and endorsing inflation forecasts at a higher frequency.
- Promptly publishing an adequate summary (un-named) of the Council deliberations.”

European Parliament has been presented with a *fait accompli* and the profession is left to appear as forever critical or unsatisfied.

3. The Definition of Price Stability

The previous definition of price stability, although stated in a convoluted way, was that inflation should be between 0% and 2%. The new definition is that inflation should be around 2%, an implicit increase. This change is welcome, yet it raises more questions than it answers.

3.1. What is a proper definition of price stability?

There is no generally accepted definition of price stability. Clearly, less inflation is better than more, but deflation is highly undesirable. To make matters worse, no central bank can precisely stir the inflation rate for two main reasons. First, there are long lags (12 to 18 months) between policy action and effect. Many shocks can – and usually do – occur in the intervening period so that the inflation outcome is the combined effect of policy actions and shocks. Second, the channels through which monetary policy operates remain imprecisely known and apparently irregular. Even in the absence of any shock, therefore, no central bank is currently able to achieve much precision in hitting a particular inflation rate. Consequently, when defining price stability, a central bank must take into account that the actual inflation rate will always fluctuate above and below the objective. In particular, avoiding deflation requires an objective far away from zero.

Probably the best definition of price stability is that it is achieved when the average citizen ceases to worry about inflation, positive or negative. In my Briefing Note for the second quarter of 2001, I drew the following conclusion:

“The average euro area citizen does not perceive any difference between inflation rates of 2% or 2.5% and, if asked, most citizens would gladly take the risk of a 3% inflation rate if that were the price to pay to avoid a potential recession. But citizens are not asked. Clearly democratic accountability is being stretched here, and the European Parliament has a role to play. The 2% ceiling is *not* in the Maastricht treaty, it is an interpretation by the ECB.”

The raising of the definition is therefore commendable. One may quibble with the fact that 2% is still at the lower end of the desirable range, and lower than in most inflation-targeting central banks (see Table 1), but that is of secondary importance. The serious problems lie elsewhere, as explained below.

Table 1. Inflation targets and forecasts (2002)

Australia	Brazil	Canada	Chile	Colombia	Czech Republic	Hungary
2-3% "central tendency" of Headline CPI inflation.	Headline CPI (tolerance band of +/- 2.5%).	2 %, target range 1-3%	Headline CPI 3%, range 2%-4%	Headline CPI 6% (2002)	Headline CPI 2%-4%	4,5 % (2002) and 3,5 % (2003).(+/- 1 %)
Iceland	Israel	Rep. of Korea	Mexico	New Zealand	Norway	Peru
CPI 2,5 % (+/-1,5%)	CPI 2-3 % (2002) , 1-3 % subsequently	3% (+/- 1%)	Headline CPI 4.5% (2002), 3% (2003)	Headline CPI 1-3%	2,5 %	2,5% +/-1
Philippines	Poland	South Africa	Sweden	Switzerland	Thailand	United Kingdom
Headline CPI 4.5-5.5 %	Headline < 4%	CPIX: 3-6% (2002), 3-6% (2004 and 2005)	CPIX 2% ($\pm 1\%$)	Headline CPI <2%	Core 0-3.5 %	RPIX: 2.5% (deviations in excess of +/- 1% require a formal explanation)

Source: Fracasso, Genberg and Wyplosz (2003) "How Do Central banks Write", *Geneva Special Report on the World Economy*, 2.

3.2. What price index?

The ECB has decided to retain the headline Harmonized Index of Consumer Prices (HICP) rather to opt for core inflation. By intent, core inflation is usually more stable than HICP inflation since it excludes some of the most volatile components of the price index, for example the price of energy or housing. The merits of each price index have long been debated and no clear conclusion has emerged. The ECB mentions that core inflation can be seen as remote from the consumers preoccupation and as suspect of manipulation. These are valid concerns. It also notes that if HICP inflation may occasionally send misleading signals, the medium term nature of the strategy justifies overlooking them. This too is perfectly acceptable and the majority practice as Table 1 shows.

3.3. How clear is the definition?

The new definition suffers from three important weaknesses.

What level?

In announcing the outcome of its review, the ECB starts with a quotation of its 1998 definition, and indicates the revision:

"Price stability is 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." Today, the Governing Council confirmed this definition (which it announced in 1998). At the same time, the Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term.

ECB press release: The ECB's monetary policy strategy, 8 May 2003

Thus we are told that "below 2%" remains the desirable level, but also that the Eurosystem "will aim to maintain inflation rates close to 2%". This statement is unnecessarily cryptic. Is it below 2% or is 2% on average acceptable, in which case there will be as many instances when inflation is above as it is below 2%? It seems that the ECB accepts that it will routinely deliver a rate of inflation that exceeds its definition of price stability, as has been the case over most of the past three years.

What acceptable range?

Since the realized inflation rate will fluctuate around the level (implicitly) targeted by the central bank, it is essential to know what is the tolerance margin that is acceptable. We need to know this margin to be able to understand and anticipate the central bank's action. As Table 1 shows, many central banks indicate what kind of fluctuations they are prepared to see. In its initial policy strategy statement, the ECB had indicated a range of 0% to 2%. No such range is presented in the new strategy. This means that the strategy does not include any prescription of what is acceptable and what is not. Deflation seems to be ruled out since the statement evokes the need to "guard against the risks of deflation", but there is no clear ceiling. In this sense, the new strategy is less precise than the previous one. As a result, the markets will now devote considerable effort to pinpoint the margin, an artificial time-consuming exercise and a source of harmful uncertainty.

What horizon?

When shocks take the inflation rate away from its desired level, how quickly will the ECB endeavour to bring it back? The new strategy repeats the previous vague wording: "over the medium run". In its May 8 announcement the ECB observes that the previous strategy has "worked satisfactorily", from which we can infer that 3 years of overshooting the 2% ceiling lies within the medium term, but how far beyond does it extend? Given the abundant criticism since 1998, the vagueness of the policy horizon is clearly intentional. The ECB provides no rationale, nor does it rebut the earlier criticism.

The absence of a clear horizon significantly reduces the ECB's accountability. Accountability is meaningless unless the agent can be blamed, or sanctioned as the case may be in the event that it does not deliver on its mission. For the ECB is, at a minimum, price stability.² The absence of any tolerance margin around the 2% benchmark – as noted below, we cannot call it a target – already cripples accountability, but a case could be made that, say, 3.5% is excessive. Should the ECB be blamed if this excessive arte occurs for one year? For two years? More? An

² At a minimum, for the European Union Treaty also requires that the ECB support activity, see Section 4 below.

unspecified horizon is, almost by definition, a flexible one, and the ECB can always argue that it cannot be faulted.

3.4. What is the difference between a definition of price stability and an inflation target?

The word “target” is conspicuously absent from the announcement. The result is an uncomfortable tension between what the ECB sees as desirable and what it intends to do. In principle, a strategy is meant to provide clear indications of what one intends to do. The ECB seems to consider that its definition of price stability can be seen as a benchmark for judging its actions:

“The announcement of a quantitative definition of price stability enhances the transparency of the overall monetary policy framework and provides a clear and measurable benchmark against which the public can hold the ECB accountable. Furthermore, it gives guidance to expectations of future price developments, thereby helping to stabilise the economy.”

Overview of the background studies for the reflections on the ECB’s monetary policy strategy, ECB, 8 May 2003

Most readers would conclude that “definition of price stability” can be read as an “inflation target” and would not want to delve into further Euro-semantics. Unfortunately, the distinction is not innocuous for two important reasons.

Democratic accountability

Proper democratic accountability should allow outsiders (the European Parliament, observers and analysts) to form a view of the ECB’s decisions as they occur. This requires a clear target and a well-specified horizon. By alluding to the “medium run” the ECB attempts to shelve itself from criticism, By further rejecting the notion of any target, the ECB explicitly asks for outsiders to wait and judge in the “medium run”. Thus, the public to which the bank is accountable can only bemoan past actions long after they were taken.

Policy regime and expectations

Quite clearly, the ECB has decided to reject inflation targeting, hence its careful choice of words, but the problem goes deeper, to the very heart of monetary policy-making. As explicitly recognized in the previous quotation, a target serves to anchor expectations, which both increases the effectiveness of monetary policy and helps to stabilize the economy. Since the ECB has no target, both properties are lost. This is disappointing as the ECB could well have announced a target while stating explicitly that its actions will not be guided solely by the relationship between forecasted and target inflation. It could thus reject inflation targeting without giving up the important anchoring role of a target.

4. The Forgotten Objective

The European Union Treaty does not just require the ECB to deliver price stability, it also demands from its central bank to “support the general economic policies”. The

ECB's definition of its mission is restrictive, a failure that the new strategy fails to deal with. It may be argued that the ECB's actions have been more in tune with the wider definition of its mission, but that does not exonerate the bank from explaining just how it will fulfil this secondary duty.

5. The New Pillars

5.1. The end of the reference value for M3 growth

The two pillars were certainly the most controversial components of the previous strategy. The prominent role attributed to money growth was generally seen as a relic of the old, much decried, strategy of the Bundesbank. Like the Bundesbank previously, the ECB has found itself forced, month after month, to justify the deviations of M3 growth from its reference value. Like the Bundesbank, it has provided a list of special reasons that all confirm that M3 suffers from erratic behaviour and that the link from M3 growth to inflation is highly unreliable over the policy horizon. This is precisely why most central banks have abandoned money-targeting.

The decision to “no longer continue a review of the reference value on an annual basis” seems a convoluted way of announcing that there will be no more reference value. Unfortunately, this commendable step is marred by the retention of the two pillars, although renamed and re-ordered. The first money growth pillar is demoted to second rank as the “monetary analysis” pillar, and M3 is now just one of many monetary aggregates to be considered. The previous second pillar now comes first, relabelled the “economic analysis” pillar. The new jargon seems to be “cross checking”, the procedure that is meant to relate the second pillar's longer-run signals to the shorter-run ones provided by the first pillar. This is but a complicated way of stating what all central banks do: studying the various available elements to form a view of where inflation is headed to.

This normalization of the ECB's stated strategy is of course welcome, but it comes encumbered with additional devices that do not serve any useful purpose and will hurt the ECB. They seem mainly designed to diminish the role of inflation forecasts and to maintain an unhealthy element of obfuscation in the communication process.

5.2. Forecasts

The ECB has started to publish its bi-annual forecasts, which it diminutively calls “projections”, in December 2001. The publication of inflation and growth forecast is a key ingredient of inflation targeting and, as such routinely performed by many central banks. Yet, even for non-inflation targeting central banks, forecasts have an important role to play. The detailed analysis of economic and monetary conditions that every central bank must perform (and that the ECB now calls its two pillars) must aim *in fine* at forming a view of economic conditions, including inflation, at the horizon at which monetary policy is effective. This is precisely what forecasts do.

Forecasts include both formal analysis, using one or several econometric models, and judgment to correct the unavoidable limitations of any model. They encapsulate the best judgment of future inflation and growth that can be made on the basis of all the

available information. The “cross checking” of the first with the second pillar closely mimics the forecasting exercise.

There is no reference to forecasts in the strategy review and the implication of the announced use of the two pillars is that the ECB continues to adamantly distance itself from forecasts. There are good and bad reasons to avoid being identified with forecasts. The main good reason is that forecasts are often wrong, partly because of the inherent imperfections of the exercise, partly because new unexpected events invariably occur. But, the cross-checking of the first by the second pillar is no different, and must lead every member of the Governing Council to form an implicit forecast. The ECB’s approach is therefore to keep these implicit forecasts confidential.

The main bad reason for keeping forecasts off the strategy process is that it removes the central bank to more precise scrutiny. Indeed, if the inflation forecast exceeds the (implicit) inflation target, the presumption must be that the central bank will raise the interest rate. If it does not, it must explain why. The result is enhanced transparency and, therefore, better democratic accountability.

5.3. Communication

ECB-watchers have long been accustomed to highly ritualised press conference by the Chairman. The litany “As regards the first pillar..., as regards the second pillar...” has been highly frustrating for it largely amounts to sanitizing communication. Indeed, this form of communication sets the terms of the debate in a framework that, as noted above, does not lead to an indispensable forecast and to the associated explanation of the policy options and decision. The maintenance of the two pillars, however relabelled, implies a continuation of this poor communication strategy.

6. Conclusion: Inflation Targeting Strategy, Again

The strategy review improves upon the previous approach, but the ECB has not seized on this opportunity to remedy the well-known limits of an otherwise successful strategy. It seems that an important consideration has been to dispel any notion that it is evolving towards an inflation targeting strategy.³ This interpretation helps understand many of the shortcomings retained in the reviewed strategy: the maintenance of two pillars, the refusal to identify a precise target, and the refusal to give forecasts the weight that they deserve.

Another interpretation is that the ECB remains hostile to the degree of transparency that most central banks have adopted by now. This interpretation is supported by the review process itself, which has been unexpectedly announced, conducted entirely internally and completed unexpectedly quickly. Under this interpretation, many features of the strategy – the two pillars, the vagueness of the definition of price stability – are to be seen as part of a desire to preserve some degree of secrecy.

³ This can only be guessed as the review carefully avoids discussing the inflation targeting option. The US Federal Reserve is the other major central bank resisting the fashion, but some of its Board members have raised the issue in public, feeding a useful debate.

A last interpretation, the one stressed by the ECB, is the need for continuity. It is indeed understandable that the ECB should not reinvent its strategy every five years. It may also be that the ECB does not want to be seen as bowing to its critics.