

Options for the ECB's Monetary Policy Strategy Review



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Hoover Institution, Stanford University, January 20, 2021



ECB launches review of its monetary policy strategy



23 January 2020

- › Review will encompass quantitative formulation of price stability, monetary policy toolkit, economic and monetary analyses and communication practices
- › Other considerations, such as financial stability, employment and environmental sustainability, will also be part of review
- › Expected to be concluded by end of 2020
- › Review will be based on thorough analysis and open minds, engaging with all stakeholders

<https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200123-3b8d9fc08d.en.html>

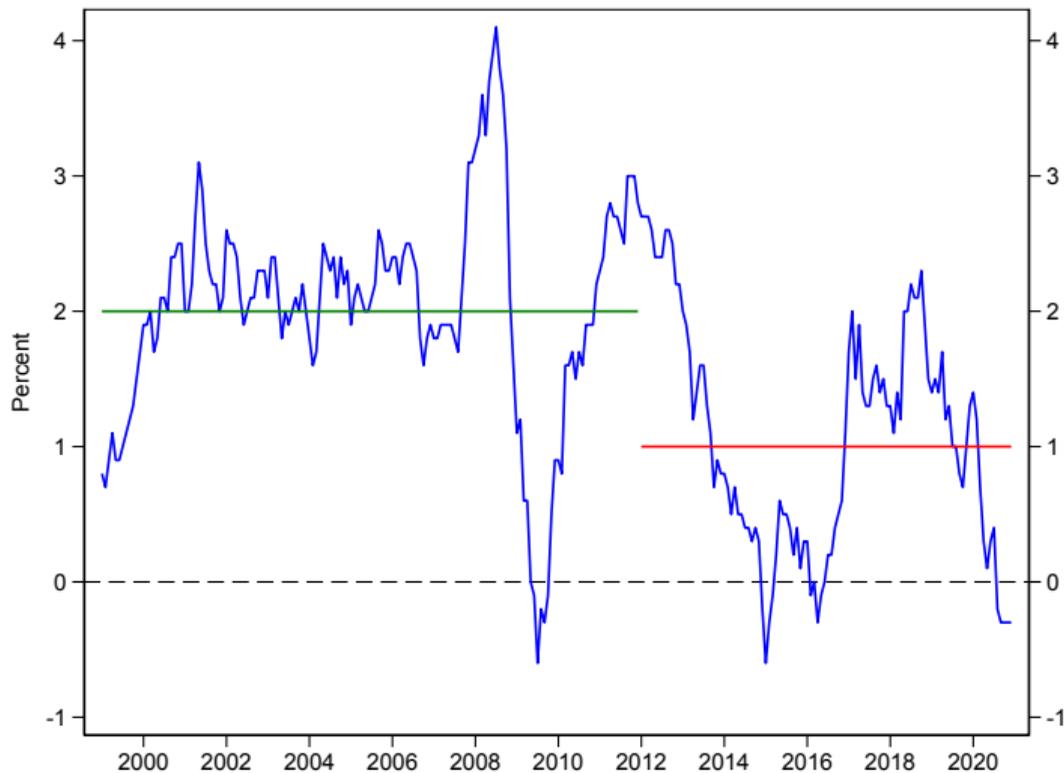


Challenges

- ▶ The ECB's mandate.
- ▶ The fragility of the euro area.
- ▶ The ECB's broad discretionary authority: *A poisoned chalice.*
- ▶ Climate change?



The ECB's lowflation policy: 2012 – ?

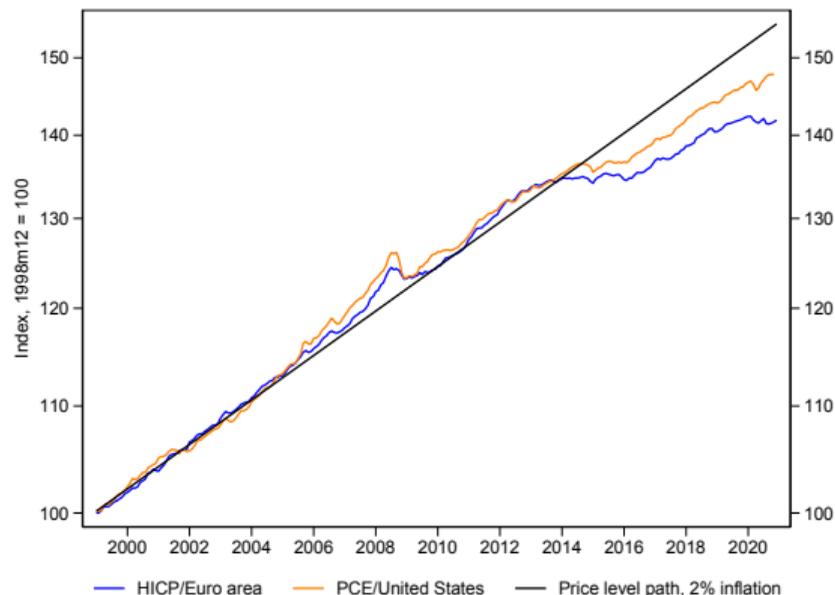


HICP, monthly data. Mean, 1999-2011 = 2.0%. Mean, 2012-2020 = 1.0%.

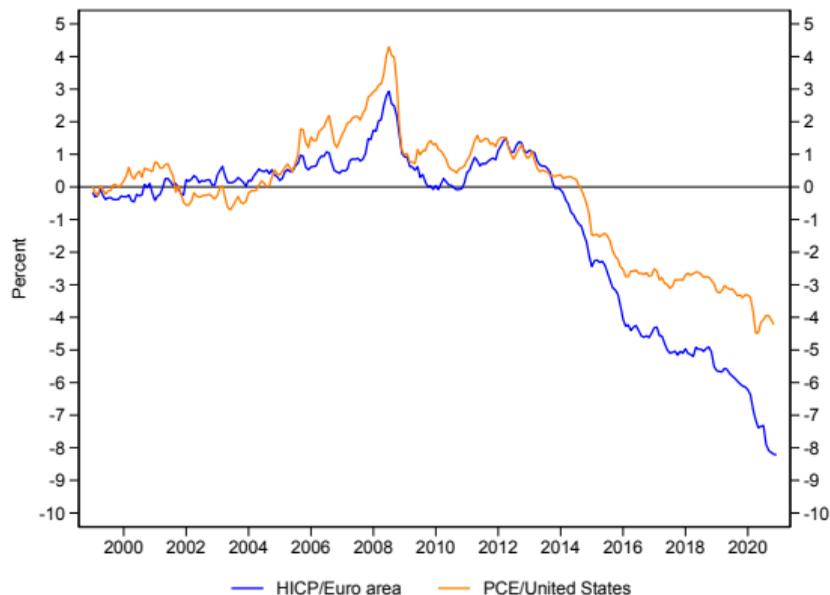


Price level relative to 2% inflation path: ECB and Fed

Price level



Price level gap

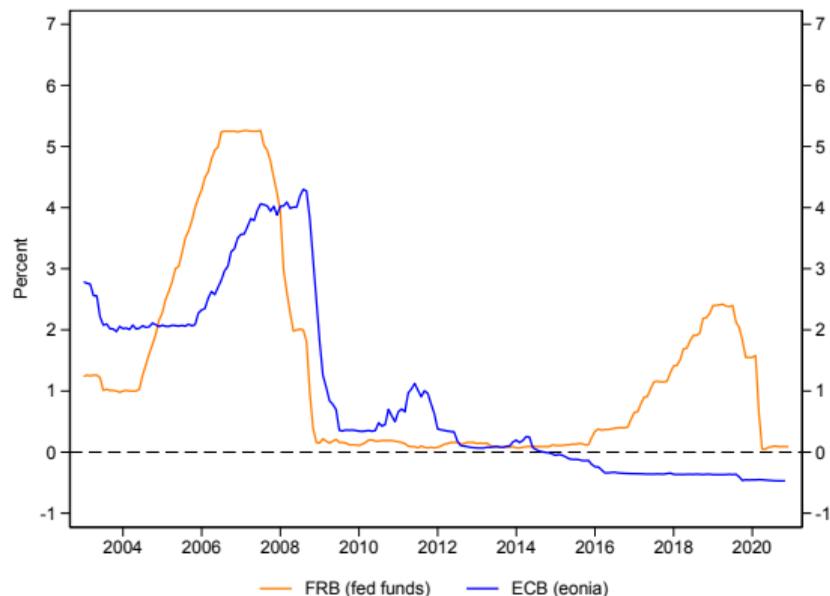


Price level path starting with 1998m12 = 100.

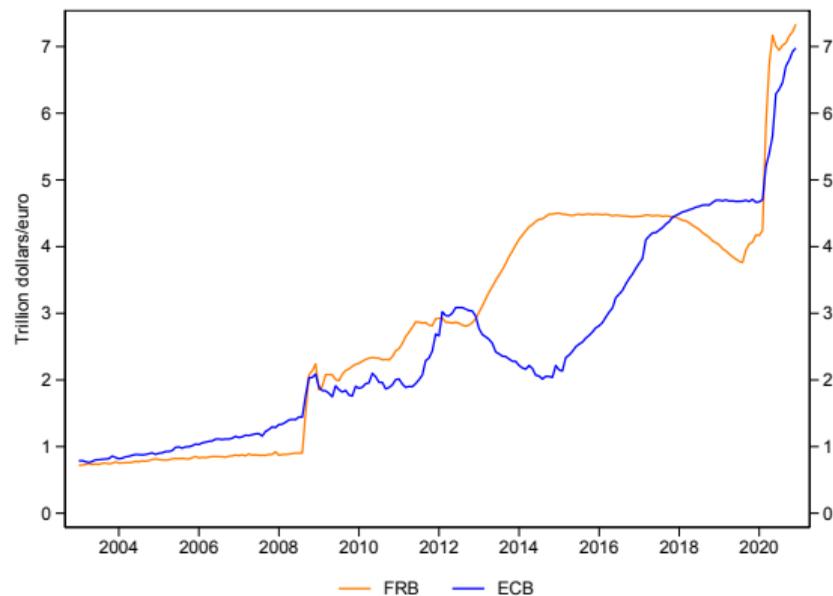


The ZLB challenge: ECB and Fed

Overnight interest rate



Size of balance sheet



- ▶ Fed: Substitute QE for rate cuts—systematically aim to achieve π^* , on average.
- ▶ ECB: Erratic and timid QE relative to Fed, better response to 2020 pandemic.



Blunder detection through the lens of inflation projections

Forecast Date	ECB Forecast		
	2014	2015	2016
Sept. 2013	1.3		
Dec. 2013	1.1	1.3	
Mar. 2014	1.0	1.3	1.5
June 2014	0.7	1.1	1.4
Sept 2014	0.6	1.1	1.4
Dec. 2014	0.5	0.7	1.3

ECB balance sheet contraction despite declining inflation projections



Advice on lowflation that went unheeded

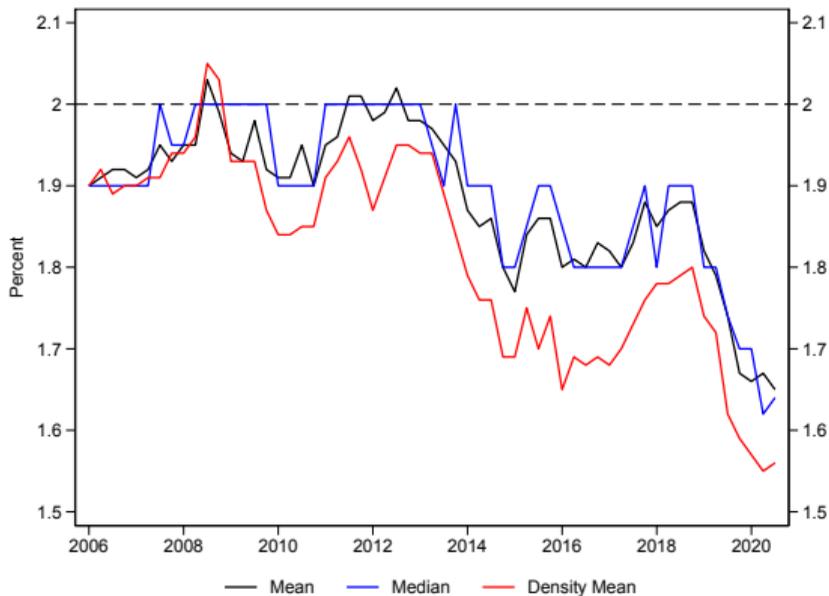
“There is the **emerging risk of what I call ‘low-flation,’** particularly in the Euro Area. A potentially prolonged period of **low inflation can suppress demand and output—and suppress growth and jobs.** More monetary easing, including through unconventional measures, is needed in the Euro Area to raise the prospects of achieving the ECB’s price stability objective.”

IMF Managing Director Christine Lagarde, 2 April 2014.



Disanchoring of euro-area inflation expectations

Long-term survey expectations



Inflation swaps



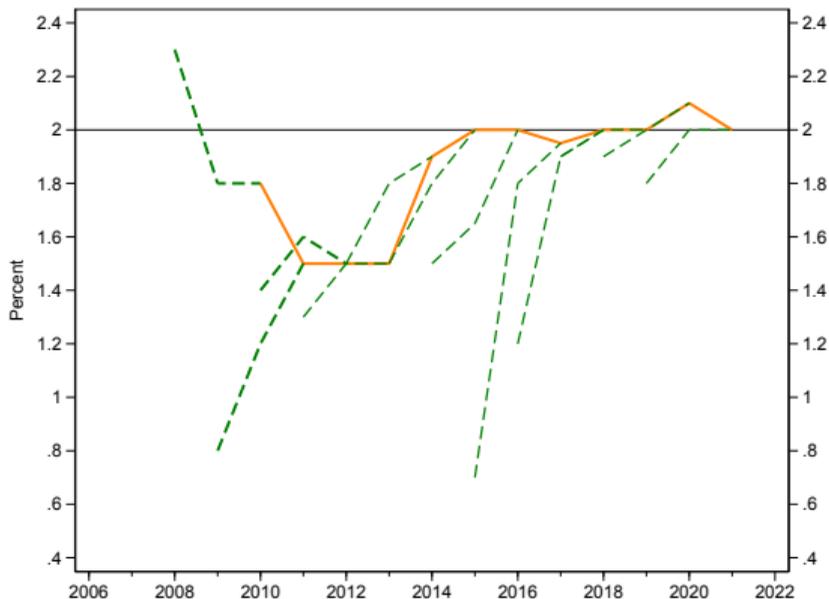
Recommendation 1: Adoption of a symmetric 2% inflation goal

- ▶ A clear target improves the effectiveness and efficiency of monetary policy.
- ▶ It anchors expectations and promotes systematic policy.
- ▶ It improves accountability, and thereby protects against political pressure.
- ▶ 2% has emerged as a global standard.
- ▶ Compare with Fed's adoption of 2% goal in 2012.

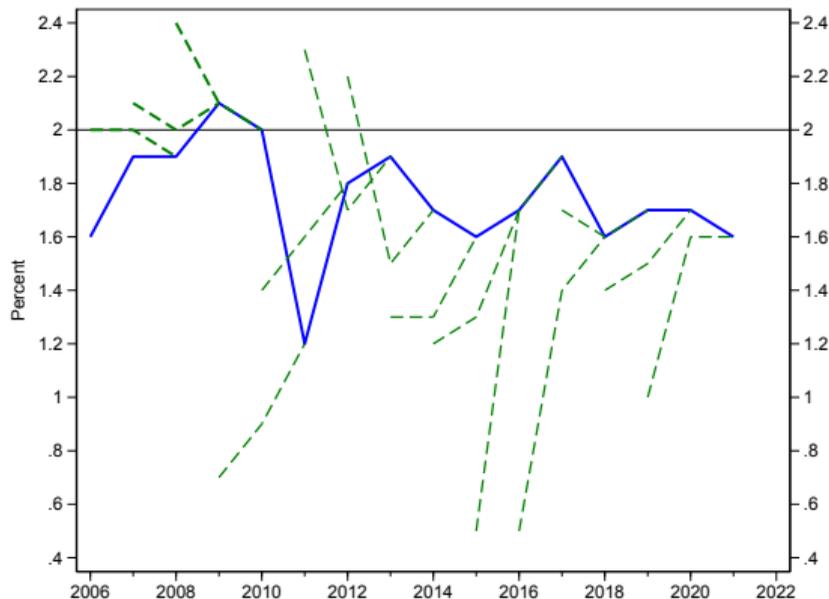


Communicating policy through inflation projections

Fed (PCE)



ECB (HICP)



Projections for first quarter of each year. Last projection shown is 2019Q1.

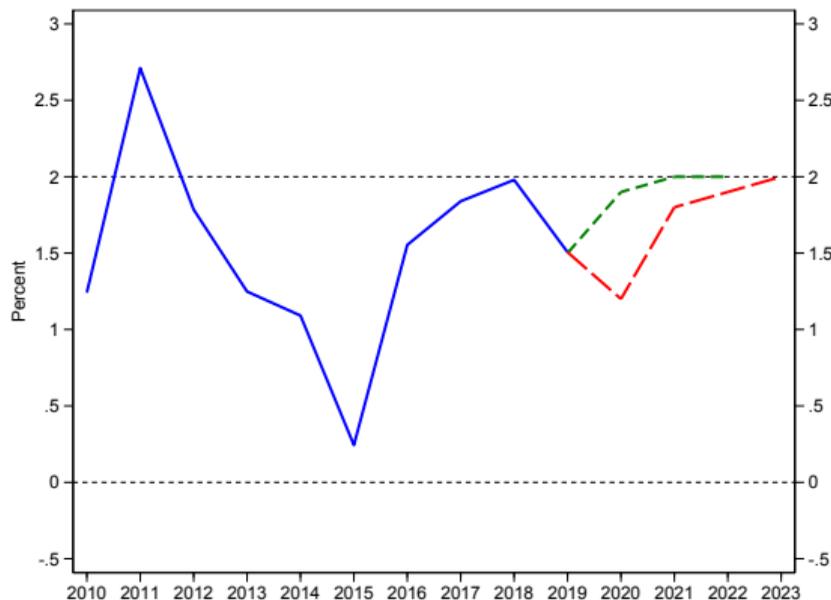
Dashed lines connect 3-, 7-, and 11-quarter ahead projections.

Solid lines connect the 11-quarter ahead projections

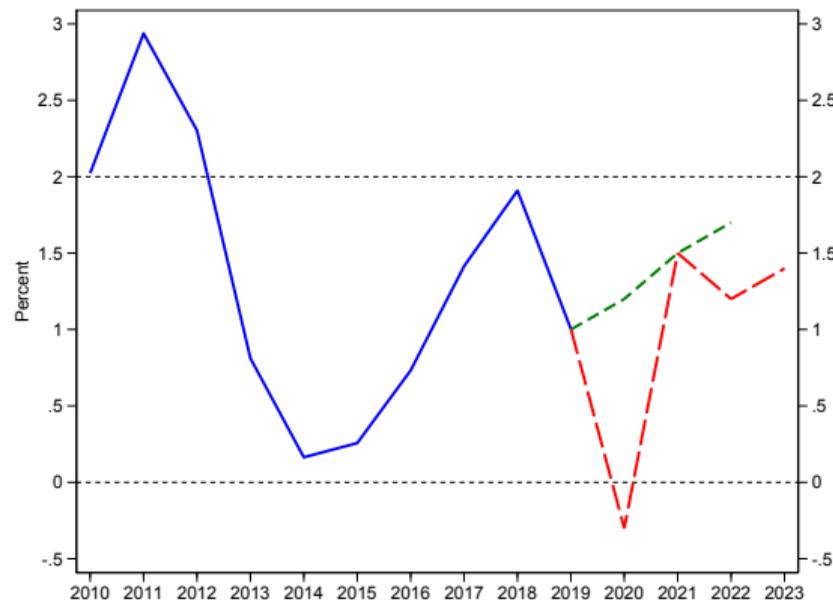


Response to pandemic: Inflation projections

Fed (PCE)



ECB (HICP)



All data and projections show Q4/Q4 inflation. **Blue: Data through 2019.**

Green: December 2019 projection. Red: December 2020 projection.



The primary mandate and beyond

- ▶ The ECB's statutory objectives and their interpretation.
- ▶ Divergence of economic outcomes in euro area.
- ▶ The impairment of the monetary policy transmission mechanism.
- ▶ The vulnerability induced by flaws in the monetary policy implementation
- ▶ The use and potential abuse of discretionary authority.



ECB objectives

“The **primary objective** of the European System of Central Banks [ESCB] shall be to maintain price stability. ...”
(Article 127(1), Treaty on the Functioning of the European Union.)



ECB objectives

“The **primary objective** of the European System of Central Banks [ESCB] shall be to maintain price stability. **Without prejudice to the objective of price stability**, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in **Article 3 of the Treaty** on European Union.”
(Article 127(1), Treaty on the Functioning of the European Union.)



ECB *secondary* objectives (Article 3 of the Treaty)

“The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at **full employment and social progress**, and a high level of **protection and improvement of the quality of the environment**. It shall promote **scientific and technological advance**.

It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child.

It shall promote economic, social and territorial **cohesion, and solidarity among Member States**. ...”

(Article 3(3), Treaty on European Union.)



ECB interpretation of mandate: 1998

As mandated by the Treaty establishing the European Community, the maintenance of price stability will be the primary objective of the ESCB. **Therefore, the ESCB's monetary policy strategy will focus strictly on this objective.** In this context, the Governing Council of the ECB has adopted the following definition: **"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%."** (ECB, 13 October 1998)



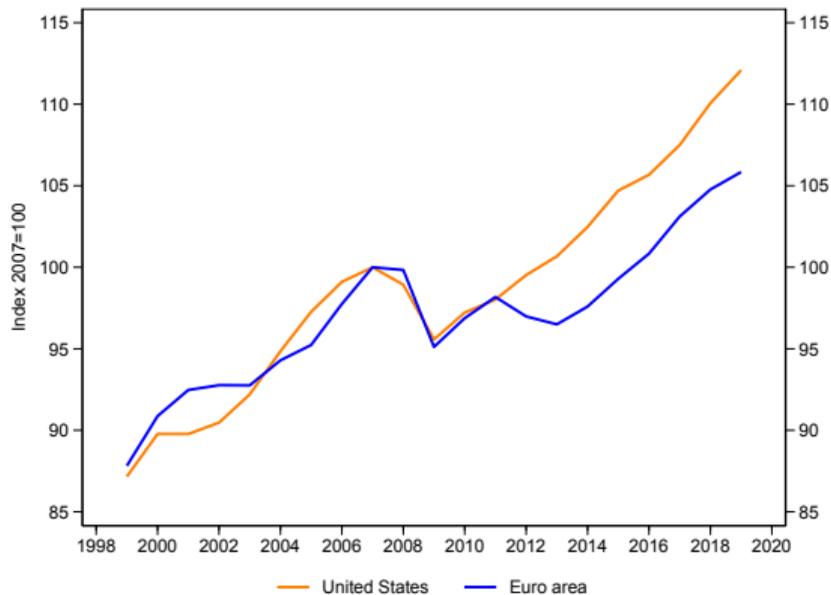
ECB “clarification” of price stability: 2003

[T]he 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, 8 May 2003)

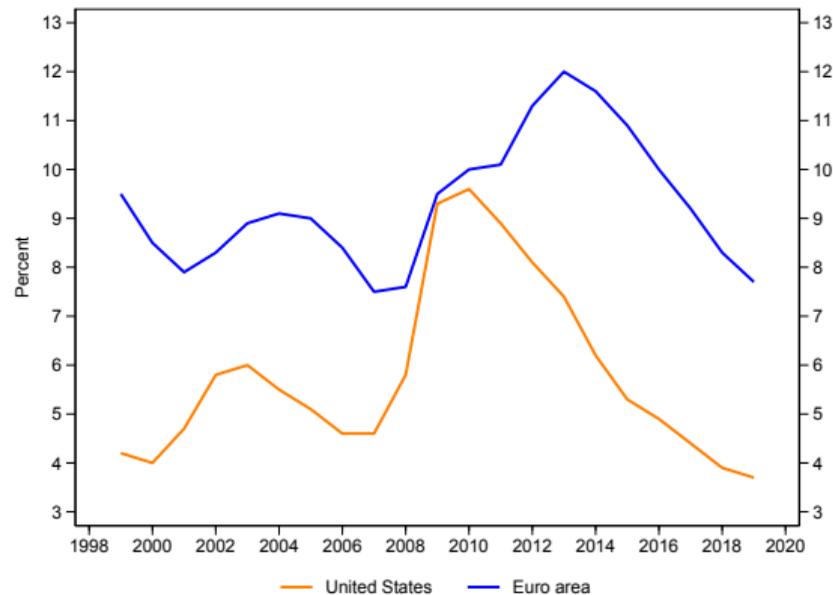


Euro area and USA 1999–2019: Economic outcomes

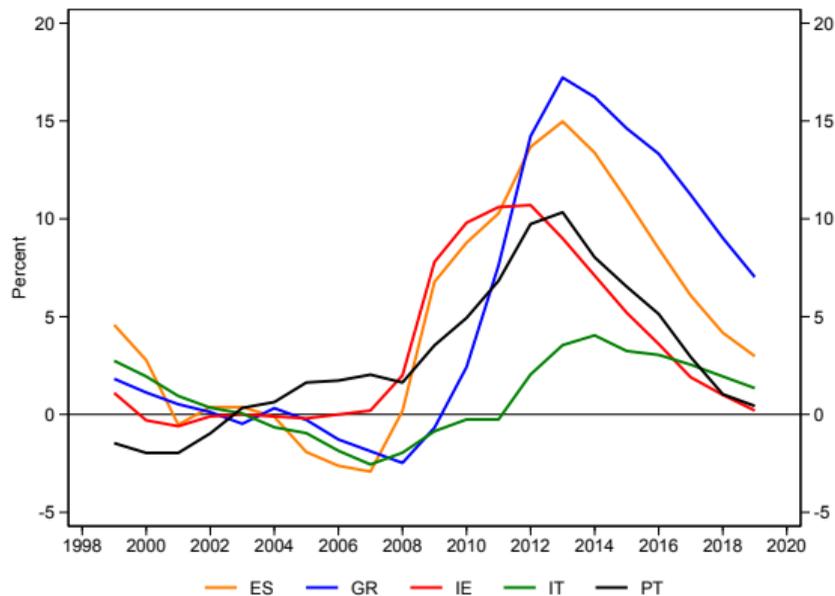
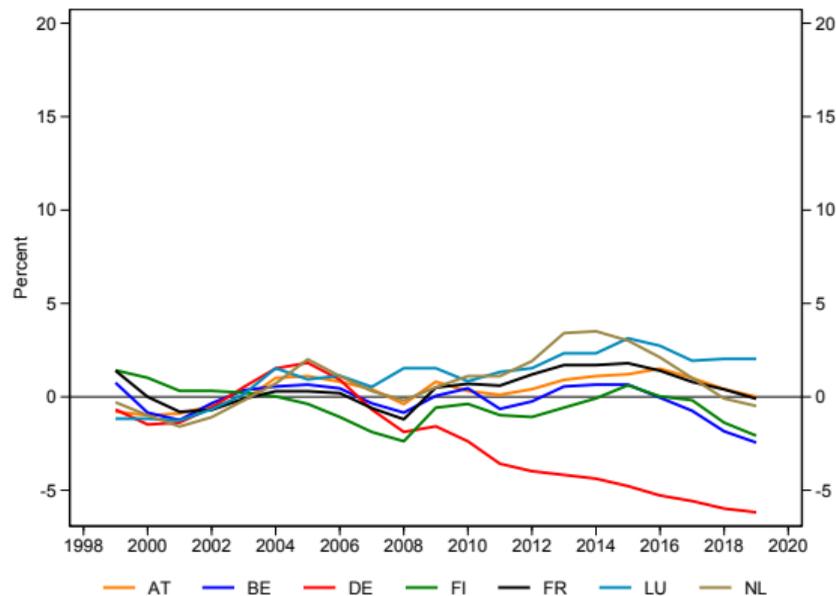
Real GDP per person



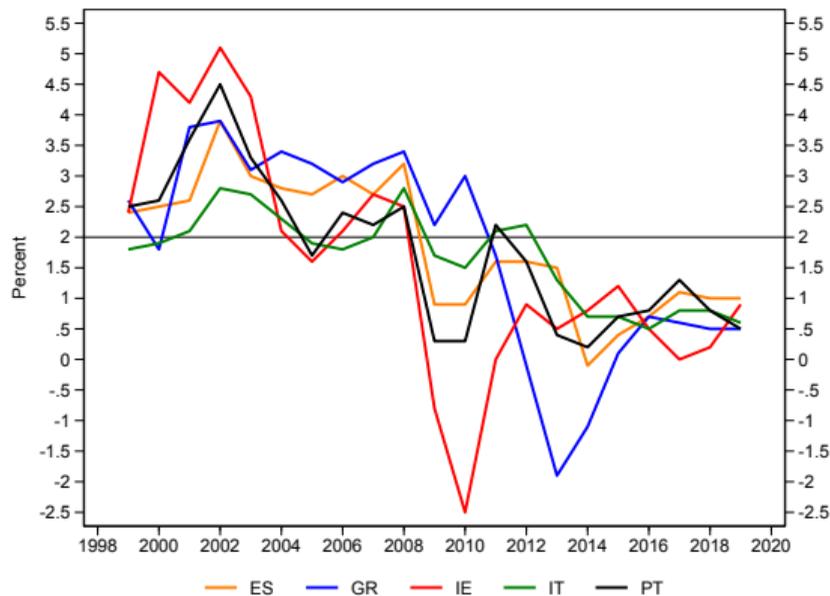
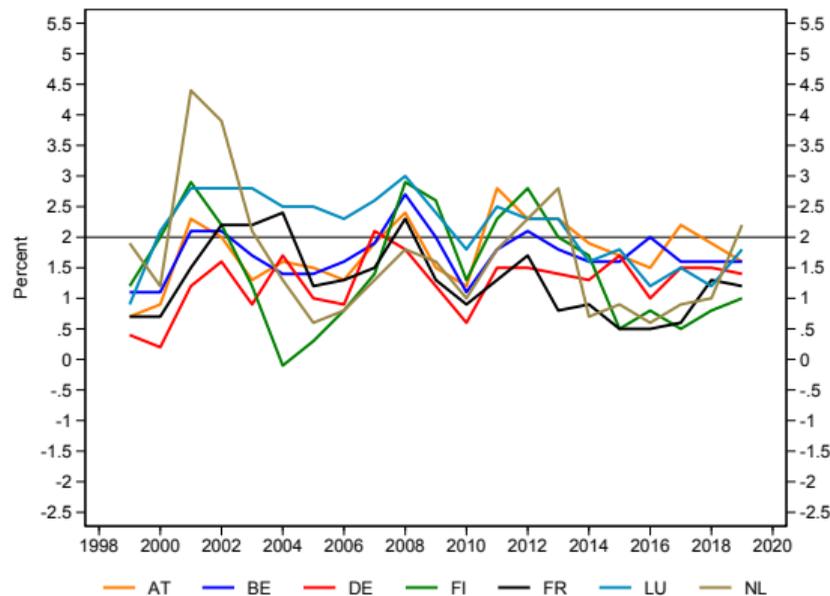
Unemployment rate



Heterogeneity: Unemployment rate relative to pre-GFC average



Heterogeneity: Core inflation outcomes

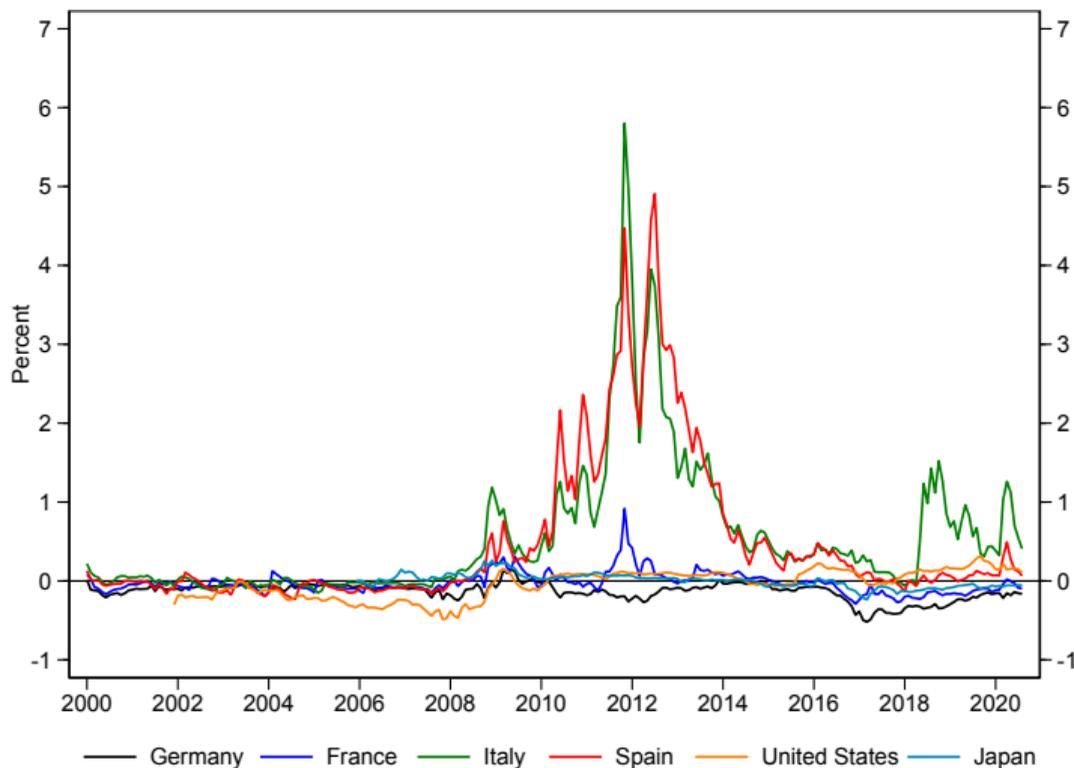


Recommendation 3: Economic cohesion

- ▶ The objective of price stability requires the ECB to defend price stability in the euro area overall **but also** to strive to maintain price stability in each individual Member State for which it is responsible.
- ▶ This argues against policies that predictably result in the uneven transmission of monetary policy and promote divergences.
- ▶ Economic cohesion is essential for protecting price stability in individual Member States. Correcting existing flaws in **monetary policy implementation** can vastly improve the ECB's ability to fulfil its mandate in this regard.



The impairment of the monetary policy transmission mechanism



Spreads of two-year sovereign yields from OIS rate in corresponding currency.



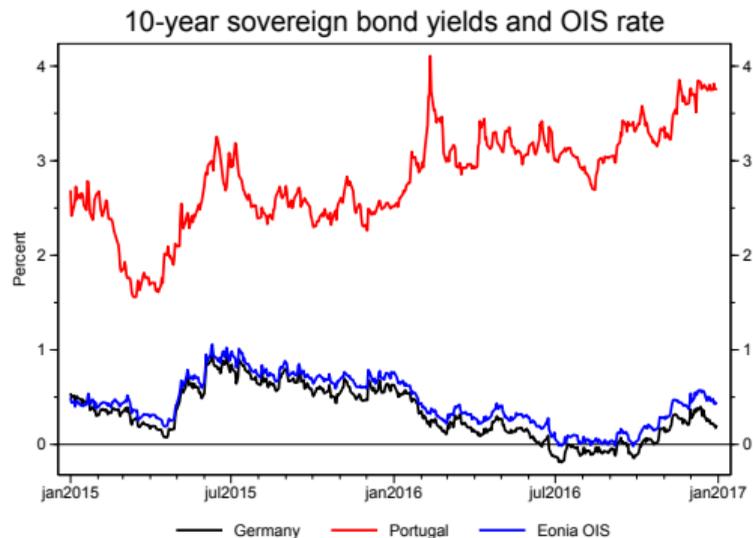
Problems with ECB's monetary policy implementation strategy

- ▶ Excessive reliance on “markets” and private credit rating agencies.
 - ▶ Cliff effects in collateral framework.
 - ▶ Improper interest rate assumptions in DSA.
- ▶ Inadvertent consequences since euro crisis:
 - ▶ Induce debt roll-over crises.
 - ▶ Validate adverse expectational equilibria in sovereign debt markets.
- ▶ Has the ECB made satisfactory use of the authority delegated to it?
 - ▶ Since the euro crisis?
 - ▶ Since start of pandemic?



Case study: The cliff effect in Portugal

“Markets are waiting anxiously for October 21st, when DBRS will update its rating of Portuguese sovereign debt. Hints from DBRS have been playing havoc with the ten-year bond yield.”
(Economist, 16 October 2016)



“The decision by DBRS means Portuguese bonds have not suffered the sharp sell-off predicted in the event of a downgrade, although it has not removed all the uncertainty for investors. . . . In April, DBRS will revisit its rating, so for the next six months, Portugal’s fate will again depend on a little-known credit agency based in Toronto.”
(FT, 24 October 2016)



The cliff effect and multiple equilibria

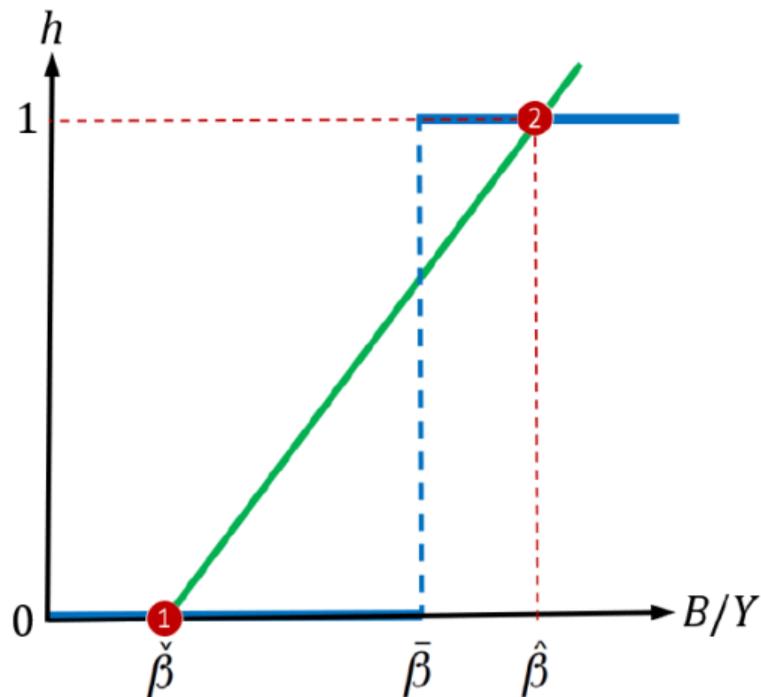


Figure 3 in Lengwiler and Orphanides (2020), "Collateral Framework."



Does the ECB lack the authority to do its job?

- ▶ The ECB may: “operate in the financial markets by **buying and selling outright** (spot and forward) or under repurchase agreement ... ” (Art. 18.1, Statute.)
- ▶ The ECB may: “conduct credit operations with credit institutions and other market participants, with lending being based on **adequate collateral**.” (Art. 18.1.)
- ▶ “The ECB **shall establish general principles** for open market and credit operations ...” (Art. 18.2.)
- ▶ “The Governing Council may, by a majority of two thirds of the votes cast, decide upon the use of such other operational methods of monetary control **as it sees fit**, respecting Article 2.” (Art. 20.)



Recommendation 6: Cliff effects in the collateral framework

- ▶ The ECB's collateral framework contains a dangerous cliff effect.
- ▶ It invites speculation and debt-rollover crises associated with adverse self-fulfilling equilibria.
- ▶ It is contrary to best practice.
- ▶ The ECB should discontinue using private credit ratings for sovereign debt.

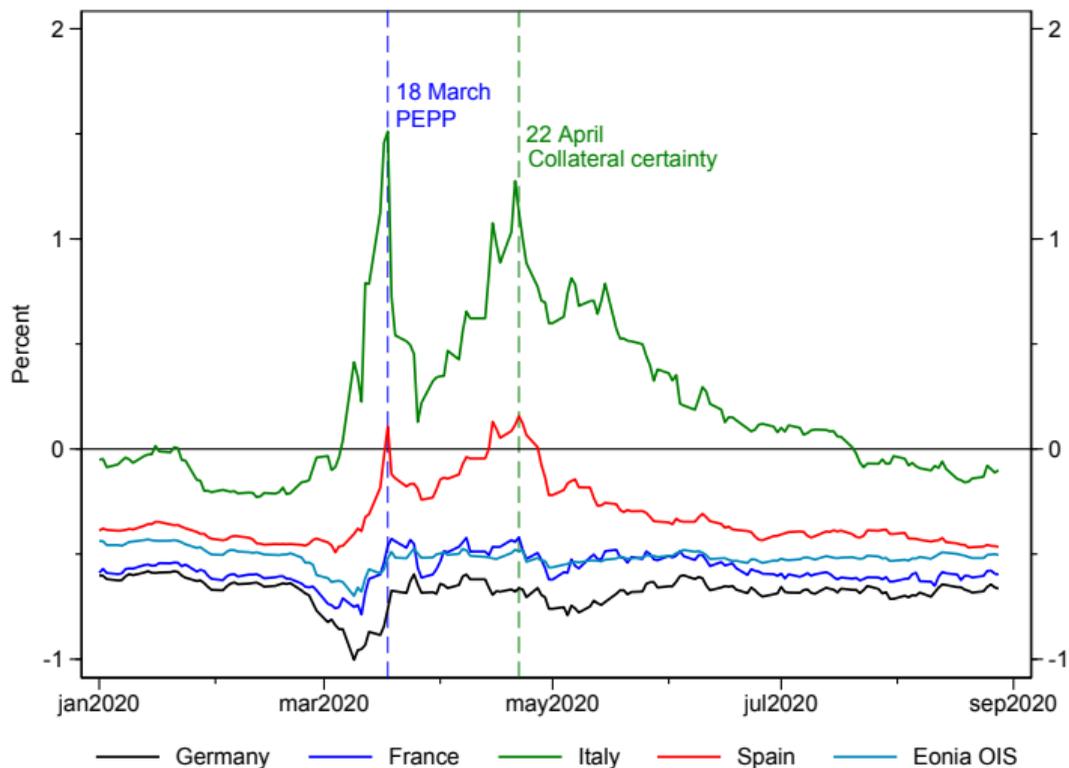


Recommendation 10: Protect against politicization

- ▶ ECB's broad discretionary authority proved to be a poisoned chalice.
- ▶ Cliff effect in collateral treatment of government debt introduced in 2005, apparently to address concerns about enforcement of fiscal rules.
- ▶ ECB should avoid the appearance that it is willing to deploy its monetary policy instruments to enforce fiscal discipline. Doing so falls outside its purview.
- ▶ The ECB should reaffirm that “ ... it is not and cannot be the ECB's role to enforce fiscal discipline and to correct shortcomings in the implementation of the Stability and Growth Pact” (Issing, 2005).



The response to the pandemic



Two-year yields on sovereign debt and eonia OIS rate.



Temporary suspension of a critical source of instability

ECB takes steps to mitigate impact of possible rating downgrades on collateral availability



22 April 2020

- › ECB to grandfather **until September 2021** eligibility of marketable assets used as collateral in Eurosystem credit operations falling below current minimum credit quality requirements
- › Appropriate haircuts will apply for assets that fall below the Eurosystem minimum credit quality requirements
- › Decision reinforces broader package of collateral easing measures adopted by the Governing Council on 7 April 2020, which will also remain in place until September 2021
- › ECB may decide further measures, if needed, to continue ensuring the smooth transmission of its monetary policy in all jurisdictions of the euro area



“Other considerations” in the strategy review

“Other considerations, such as **financial stability**, **employment** and **environmental sustainability**, will also be part of the review.”

<https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200123-3b8d9fc08d.en.html>

Compare with clauses in Article 3 of Treaty:

“full employment and social progress”

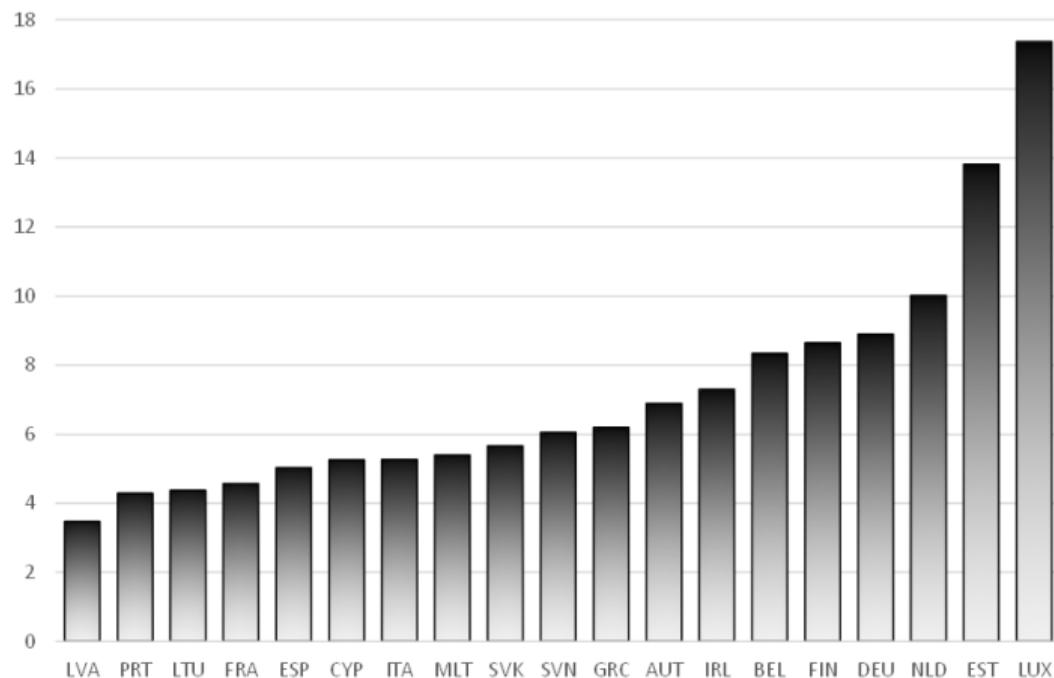
“quality of the environment”

“scientific and technological advance”

“cohesion and solidarity among Member States”



Carbon footprinting of EMU Member States



- ▶ Improve incentives by penalizing government debt of worst offenders?
- ▶ A legitimate use of a central bank's delegated authority?



Recommendation 4: Other objectives (such as climate change)

- ▶ Some important objectives of the Union, as stated in Article 3 of the Treaty, are only vaguely related to the ECB primary mandate and core central banking functions.
- ▶ The ECB should abstain from prioritizing objectives (such as climate change) over other important objectives (such as scientific and technological advance).
- ▶ Doing so would be a distraction from the ECB's legitimate tasks, risk its politicisation, and compromise its independence.



Discussion

- ▶ The ECB's monetary policy strategy review presents a unique opportunity.
- ▶ The ECB is the most important institution for the success of the EMU.
- ▶ With suitable modifications of its monetary policy strategy, and better use of the immense authority delegated to it, the ECB can greatly improve its success in fulfilling its mandate.

