

# BRIEFING PAPER

## Inflation targeting – an alternative monetary policy strategy for the ECB ?

by

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## **Executive Summary**

### **Inflation targeting – an alternative monetary policy strategy for the ECB?**

The two pillar strategy of the ECB may lead to conflicting signals for monetary policy, as is presently the case. The problem is seen in the way the ECB communicates the conflicting outcomes of the two analyses. Analysts feel they do not really know e.g. why the ECB presently leaves interest rates unchanged. The fear is that this uncertainty about the underlying reasoning feeds into inflation expectations and hampers the effectiveness of monetary policy.

The most prominent candidate to replace present ECB strategy is inflation targeting. The idea is that a quantitative target enables the general public to form expectations fairly easy and that people will behave according to these expectations. Three examples of inflation targeting, the central banks of UK, Canada and of New Zealand, are compared to the ECBs strategy. It turns out that even without inflation targeting the ECB succeeded in stabilising expectations at least as good as the other central banks such that despite actual inflation pressures from energy prices there is no deterioration of expectations that may reduce the effectiveness of monetary policy.

As the analysis shows, there is no fundamental problem. Despite its relatively complicated target structure and the somewhat difficult present situation the ECB has succeeded to establish inflation expectations that are basically in line with the target. A fundamental communication problem does not seem to exist. Nevertheless marginal improvements are possible. Indeed, the ECB should skip the second pillar. Instead monetary aggregates should be routinely incorporated into the usual inflation forecast. Basically this amounts to the recommendation to shift from the two pillar strategy to a one pillar strategy of inflation targeting. Furthermore the ECB should rephrase its target in favour of a symmetrical interval around the target rate, reaching from 1 to 3 %. This simplifies the communication of why and how the ECB reacts only sluggishly to external price shocks. As long as just external energy prices drive the inflation rate upwards there is no need to worry. Only if domestic second round effects occur the ECB must act swiftly.

## 1. Introduction

The monetary policy strategy of the ECB has been frequently criticized (cf. Sorbe/Wollmertshäuser 2007). The basic problem is that the two pillar strategy may lead to conflicting signals for monetary policy, as is presently the case. Hence, it is very difficult for the ECB to explain her action or non-action to the public.

The present situation is seen as a good example for a bad practice. Inflation rates are presently well above the inflation target of close to but lower as 2 percent. Nevertheless the Euro area is not in a typical inflationary environment. Wage rises that typically soar in case of inflation still increase only moderately. Against this backdrop an inflation triggering wage-price spiral is highly unlikely. The reasons why inflation is relatively high are relative price shocks, not a rise in the aggregate price level stretching more or less over all goods and services markets. In particular, energy prices have risen significantly year by year. This reflects on the one hand higher global demand with supplies being hampered by international policy turmoil of varying nature (war in Iraq, bad weather in the Caribbean etc). But on the other hand a structural change in price formation is the major driving force. Prices on energy markets are more and more determined on financial markets trading forward contracts. In this setting actual supply and demand are of minor importance. Instead, there is more speculative behaviour but also more forward oriented trading in the light of limited oil resources. All this has contributed to the relative rise of energy prices, but this is not inflation. Consequently most inflation forecasts assume that price rises will fade and inflation will return to the stability target. Hence, there is no need to tighten monetary policy.

The second pillar of ECBs monetary strategy on monetary developments, on the contrary has indicated since years that monetary policy is too expansionary, since the growth of the relevant monetary aggregates is well above the once defined reference value of 4.5 %. Consequently, monetary policy should be tightened. The problem is seen in the way the ECB communicates the conflicting outcomes of the two analyses. Analysts feel they do not really know why the ECB presently leaves interest rates

unchanged. The fear is that this uncertainty about the underlying reasoning feeds into inflation expectations. If these start to rise because market participants think that the ECB should follow a tighter policy, price stability is endangered. Employees start to ask for higher wages and firms start to charge higher prices. In order to ensure stable expectations the ECB is asked to follow a more clear-cut strategy that allows only for non conflicting monetary analysis outcomes. In that case, policy actions of the ECB can be explained exclusively in the light of that strategy and there is no room for speculations that may destabilise inflation expectations. Beyond doubt these arguments show some logic. However it is remarkable that inflation expectations of the very same analysts, who fear unstable expectations, are - as ECB monthly bulletins show - stable, despite the supposedly unclear strategy. Nevertheless a replacement of the present strategy is recommended.

The most prominent candidate to replace present ECB strategy is inflation targeting. The strategy will be outlined in the next section and some experiences will be discussed. The final section deals with recommendations for the ECB strategy.

## **2. On Inflation Targeting**

The basic idea is that a central bank sets its own quantitative targets and reveals them to the public. A quantitative target enables the general public to form expectations fairly easy and people will behave according to these expectations. If the central bank fixes an inflation target, it is assumed that everybody incorporates the target when fixing wages and prices. In doing so price stability is ensured without the necessity of a central bank to cool the economy down by a stabilizing recession or to stimulate it by a very expansionary monetary course. Boom and bust cycles should be overcome this way.

There is a distinction between strict and flexible inflation targeting (Svensson 2007). The former means, a central bank should select an inflation target only. The target is defined as an inflation rate or an interval of inflation rates. Monetary policy should then be designed to meet the target. A flexible inflation target strategy additionally includes an output target, more precisely an output growth target. Then the central bank is obliged to attempt to meet both targets at each point of time. A more complex flexible inflation target would even add targets referring to the variation of monetary instruments, interest

rates (Svensson 2007). Since central bankers may be afraid to change interest rates too frequently, a minimisation of changes may also be a target. Since frequent changes may disturb expectations on the direction of monetary policy, central banks should attach a certain weight to each target and accordingly design their monetary policy appropriately. Some scholars (Svensson 2007) even demand that a central bank should publish these weights too, to inform the public precisely on the target function.

A very transparent central bank following an inflation targeting approach could also reveal information on the instrument used. In order to do so, it is necessary to publish forecasts on inflation without changing interest rates and as a second step the corresponding path for interest rates. With all these information provided, the general public is supposed to be able to form sound expectations anchored around the price stability target of the central bank. This setting is seen as ideal for monetary policy.

### **3. Three examples of Inflation Targeting**

There are three prominent examples of central banks following an inflation targeting approach. These are Great Britain, New Zealand and Canada. In the UK the inflation target has been set by the government at 2 %. The bank is accountable to the parliament and the wider public to meet the target. If head line inflation trespasses the borders of an interval reaching from 1 to 3 %, the governor of the Bank of England has to write an open letter to the Chancellor to explain why this happened and to outline proposals how inflation can be brought back to the target within reasonable time. Thus there is some limited flexibility for pressure on prices to unfold, but there is strong political pressure for the Bank of England to meet goals agreed upon. In order to inform the public on its monetary policy action and to collect information on inflation expectations, the Bank of England carries out sophisticated surveys on the general public views and expectations on price developments. On the one hand they serve to detect unfolding inflation expectations on time. On the other hand the results of the surveys are published in order explain monetary policy action.

In New Zealand there is a formal agreement between the Minister of Finance and the Reserve Bank of New Zealand on policy targets, called Policy Target Agreement (PTA). It is bargained with each new incoming governor of the central bank. The stability goal is

not exclusively defined by the government as in the UK. The present PTA from May 2007 states that price stability is defined as an inflation rate interval reaching from 1 to 3 percent on average over the medium term. In quarterly monetary policy statements the central bank has to explain what it has implemented since the last statement and what it proposes to achieve price stability. Furthermore a statement is made giving an outlook on the monetary policy plans for the next five years.

The Canadian inflation targeting is stricter. The Bank of Canada has to keep inflation near 2 % and within a target range of 1 to 3 %. This is much more restrictive than in New Zealand where only the interval has to be observed and this only “on average” and in the medium run and in the UK where the central bank just has to explain deviation and show a way back to the interval. But while inflation is measured in terms of total CPI inflation, that means headline inflation in the UK and New Zealand, the bank of Canada uses core inflation as operational guide. Core inflation is seen as a more reliable indicator of future inflation. Doing this, the medium aspect is in fact also included into the Bank of Canada strategy, but strictly within the interval. This strategy is – as in New Zealand – based on a joint commitment on inflation targets of the government and the central bank.

If these settings are compared to the ECB’s institutional framework, there are two fundamental differences and a lot of similarities with differences in detail only. The first difference is that there is no explicit commitment of the ECB to price stability for which it can be held responsible by ECOFIN or by the European Parliament. The instrument of a joint target statement is not applied in the Euro area. There is only the general obligation of the ECB to ensure price stability as its predominant goal under the provisions of the Maastricht treaty. That does not include a quantitative target or target range for tolerated inflation. The quantitative target of below but close to 2 % has been set only by the ECB itself. Against this backdrop it is fair to conclude that the ECB is significantly less accountable than the central banks of New Zealand and Canada. The second fundamental difference is the two pillar strategy. Instead of following a single target function there are two, creating the respective communication problems outlined above.

The minor differences refer to the quantitative inflation target. In this respect the ECB is somewhat stricter and vaguer at the same time than the other central banks. On the one

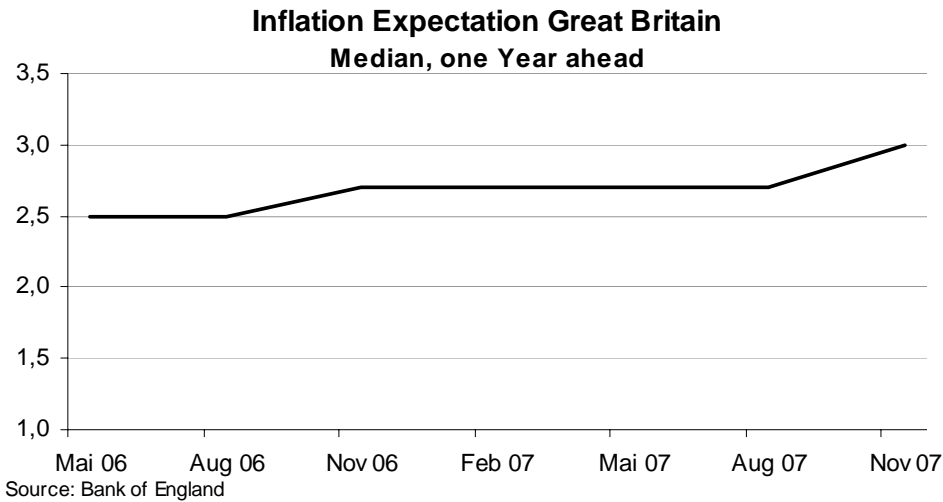
hand the ECB aims to achieve a very specific inflation rate of slightly less than 2 % instead of an interval as the other central banks. This is far more challenging. On the other hand it wants to achieve this goal “in the medium run”. Deviations are allowed but only for an undefined limited space of time and with no specific maximum or minimum rate mentioned. In the UK, New Zealand as well as in Canada the interval borders have to be observed. In Canada this has to be the case at each point of time, in New Zealand on average and in the UK after a reasonable time of adjustment.

Taking all these provisions together, obviously one cannot say that the goals of one central bank are significantly stricter than those of the others. But it is clear that the ECB strategy is much more difficult to communicate because of the two pillar strategy and some vagueness of the inflation target definition. Moreover the ECB is less accountable for achieving the target.

#### **4. Are inflation expectations affected?**

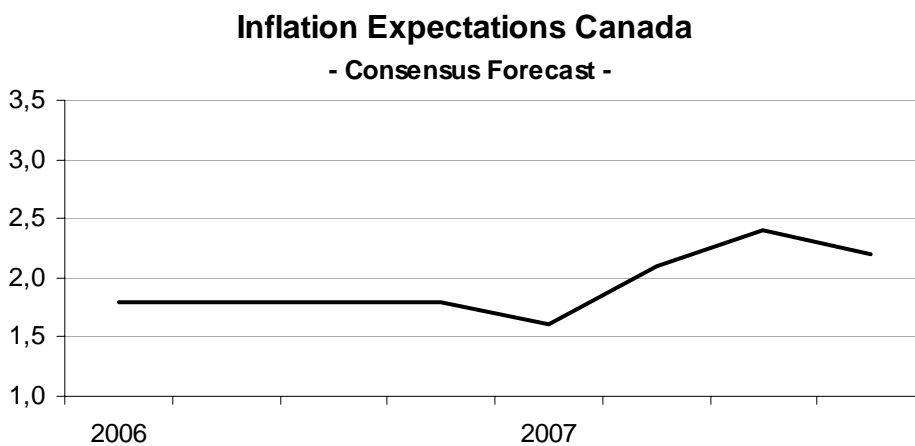
The decisive question is whether the institutional setting in the Euro area shows detrimental effects on inflation expectations. This is especially important at a time when inflation rates are above target as is presently the case in the Euro area. If the already and for quite some time elevated inflation rates fed into expectations, it would get more and more difficult to return to price stability without a stabilizing recession. Looking at recent developments of inflation expectations there are interesting differences to be found.

Figure 1



In the UK inflation expectations have been subdued until autumn last year. But the November survey indicated a significant acceleration to 3 % while actual inflation is still even slightly below the target rate.

Figure 2



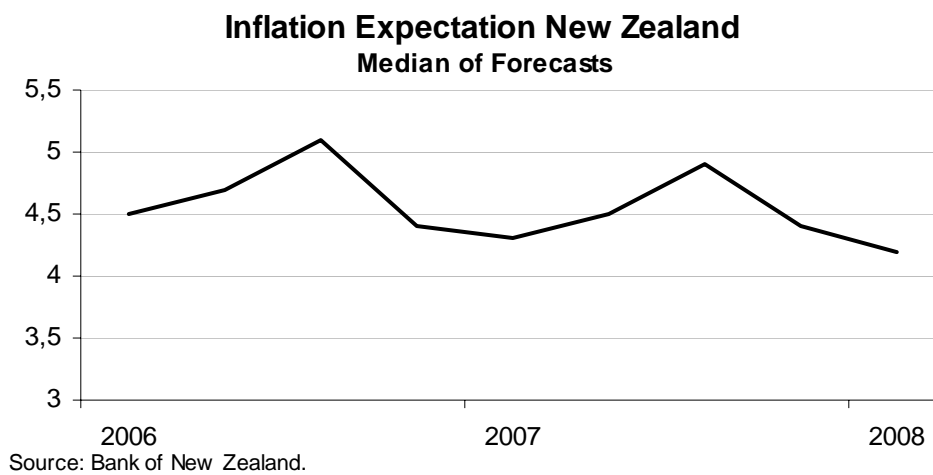
In Canada inflation expectations are a slightly above the 2 % mean of the target interval. At the same time, medium term forecast are perfectly in line with the target. Recent



headline inflation is with 2.2 % indeed slightly above the mean, but core inflation with only 1.4 % lies well below it. Both figures are within the target range. Hence there is no problem with inflation expectations in Canada and there are also no problems with inflation.

The situation is different in New Zealand. With 3.2 %, headline inflation is above 3 %, thus outside the medium term target range, and so are expectations (4.0%).

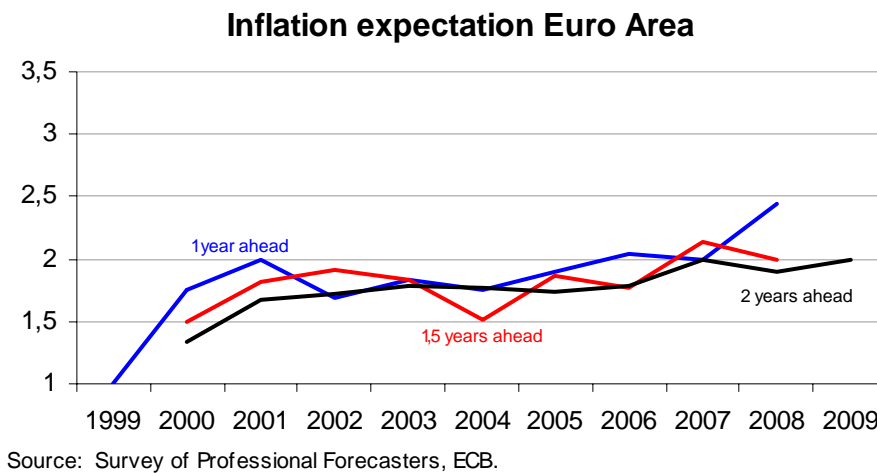
Figure 3



Hence, despite inflation targeting and very explicit rules price stability is endangered in New Zealand. The problem is - as in Europe - that energy prices soar while domestic price pressure is still subdued.

In the Euro area however there is almost no effect as far as expectations are concerned.

Figure 4



Only short term expectations (1 year ahead) are a slightly above the medium term target. Longer term outlooks are perfectly in line (2 years ahead) with the target, while headline inflation is above target. Hence even without inflation targeting the ECB succeeded in stabilising expectations such that – despite actual inflation pressures from energy prices – there is no deterioration of expectations that may dampen the effectiveness of monetary policy.

## 5. Recommendations for the ECB strategy

First of all it seems fair to state that there is no fundamental problem. Despite its relatively complicated target structure and the difficult present situation the ECB has succeeded to establish inflation expectations that are basically in line with the target. A fundamental communication problem does not seem to exist. Nevertheless marginal improvements are possible.

The two pillar strategy is indeed very complicated to communicate. Furthermore the monetary pillar has not proven very reliable during the recent past (Bordes/Clerc/Marimoutou 2007). Therefore the ECB should skip it, since it may disturb expectations to some extent, especially at times when there are conflicting signals from both pillars. Instead, monetary aggregates should be routinely incorporated into the usual inflation forecast. If they are relevant for future inflation, they should be considered

as being part of the strategy. Basically it amounts to the recommendation to shift from the two pillar strategy to a one pillar strategy of inflation targeting.

In order to calm excitement on any deviation from the 2 % medium target rate, the ECB should – as the Bank of Canada – to rephrase its target in favour of a symmetrical interval around the target rate, reaching from 1 to 3 %. This simplifies the communication of why and how the ECB reacts only sluggishly to external price shock as is presently the case. As long as external energy prices drive the inflation rate upwards there is no need to worry. Only if domestic second round effects occur the ECB must act swiftly. All these measures will only marginally improve the communication record of the ECB. This should not be surprising, because the first pillar of the present strategy is basically a way of inflation targeting. Its signals are only somewhat disturbed by the second pillar. Hence restraining monetary policy on one clear-cut pillar may help to some extent.

What is more fundamental for monetary policy is that the ECB should communicate that output also plays a role in its strategy. Hence the ECB should follow a strategy of flexible inflation targeting. There is no conflict with its primary goal of price stability as long as the weights are set appropriately and output developments also enter the inflation forecast. Sluggish output then would show a twofold impact. First it would usually reduce the inflation forecast and second it would also constitute a violation of targets in its own right. This kind of target change would have more beneficial effects on monetary policy than just changing the way of communicating the price stability target.

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