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Priorities for Review of the ECB's Monetary Policy Strategy



Policy Department for Economic, Scientific and Quality of Life Policies
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Abstract

Lower neutral rates of interest have eroded the policy space necessary to fight recessions. Against this backdrop, several central banks are re-assessing how their strategy and tools can be refined to best achieve their goals. The ECB should be no exception. Its strategy review should focus on redefining the inflation objective and on developing contingency plans for using its statutory authority creatively to achieve its mandate.

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CONTENTS

LIST OF BOXES	3
LIST OF FIGURES	3
LIST OF ABBREVIATIONS	4
EXECUTIVE SUMMARY	5
1. INTRODUCTION	6
2. MOTIVATION FOR A REVIEW	7
3. SCOPE AND FORMAT OF A REVIEW	9
4. REVIEW PRIORITY 1: REDEFINING PRICE STABILITY	12
4.1. Background	12
4.2. Recommendation	13
5. REVIEW PRIORITY 2: EXPANDING THE SET OF INSTRUMENTS	17
5.1. Background	17
5.2. Recommendation	17
6. QUESTIONS FOR MEPS	21
REFERENCES	22

LIST OF BOXES

Box 1:	The ZLB, the ELB and the Reversal Rate	11
Box 2:	The Costs of Very Low Inflation	14
Box 3:	Inflation Makeup Strategies	16
Box 4:	The Two-Pillar Strategy and Monetary Aggregates	20

LIST OF FIGURES

Figure 1:	Estimates of the Neutral Real Interest Rate	8
Figure 2:	ECB Key Official Rates	11
Figure 3:	Headline and Core CPI Inflation	12
Figure 4:	M3 Reference Value and Growth Rate	20

LIST OF ABBREVIATIONS

APP	Asset Purchases Program
BoC	Bank of Canada
CPI	Consumer Price Index
ECB	European Central Bank
ELB	Effective lower bound
Fed	Federal Reserve System
HM	Helicopter money
LFL	Lower for longer
NIT	Nominal Income Targeting
PLT	Price Level Targeting
ZLB	Zero lower bound

EXECUTIVE SUMMARY

- Lower neutral rates of interest have eroded the monetary policy space to fight the next recession for central banks around the world. Against this backdrop, several of them are reviewing their strategy and framework to see if they can be improved.
- In the euro area, the typical process of interest rate normalisation that takes place during a recovery has not even started, so the ECB has even less scope than other central banks to cut policy rates.
- The ECB is, however, well placed to improve its strategy and framework, especially given the high degree of discretion that it enjoys compared to other central banks when it comes to introducing new policy instruments.
- The paper recommends that the ECB start a broad review of its strategy along the lines of those happening in Canada and Sweden. In particular, the ECB should not follow the Federal Reserve in its decision to exclude a redefinition of its inflation objective from the review.
- The paper views (1) the redefinition of the price stability objective and (2) establishing contingency plans for using new instruments as the two most urgent elements on which the review should focus.
- The ECB should redefine price stability as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area close to 3%. By providing a higher starting point for bond yields across the yield curve, a higher inflation target could provide a total increase in policy scope that is equivalent to a 300 basis points cut in the policy rate.
- The ECB should not only detail how the parameters governing the use of its current instruments could be modified to provide more stimulus but also explore adding new instruments to its toolkit such as equity purchases and outright cash transfers to households.

1. INTRODUCTION

Monetary policy reviews are used to assess whether, and in what possible ways, a central bank's strategy, tools, and communication practices can be refined to achieve and maintain its goals as consistently and robustly as possible (Clarida 2019). The Federal Reserve System (Fed) and the Bank of Canada (BoC) initiated monetary policy reviews in 2018. European Central Bank (ECB) President Christine Lagarde signalled in September that she would be open to doing the same for the euro area.

This paper discusses the motivation for performing a monetary policy review at the ECB and what such a review should look like. It also provides background and policy recommendations for some elements of the ECB's monetary policy strategy. We focus these recommendations on two urgent elements: (1) the redefinition of price stability and (2) the need for additional monetary instruments. Other elements, such as the two-pillar analysis or the communications framework, could be improved at the margin. But they are far less important and should not detract from the requisite focus on these most urgent challenges.

2. MOTIVATION FOR A REVIEW

Performing an ECB monetary policy review would be worthwhile for at least three reasons.

First, because of the decline in the neutral rate of interest, policy rates in the euro area have lingered at the effective lower bound (ELB) for several years. The reduced scope for conventional policy easing associated with a lower neutral rate of interest was an important factor underlying the decision by the Bank of Canada (Wilkins 2018) and the Fed (Clarida 2019) to start reviews of their monetary policy strategies.¹ Figure 1 illustrates that, since the last review of the ECB strategy in 2003, the decline in the neutral real interest rate has been at least as important in the euro area as in other advanced economies. With ECB policy rates at their ELB, the ECB has less conventional ammunition to fight the next economic downturn than other central banks.

Second, the ECB is particularly well-positioned to improve its toolkit given the flexibility embedded in its mandate. Not only does the ECB possess broad discretion in using all its tools in a necessary and proportionate way to achieve its objective (Draghi 2019) but the set of tools it can use is wider than most other central banks. The Fed's asset purchases are, for example, limited by law to debt issued or guaranteed by a sovereign government or federal agency. It is not authorized to buy equities or corporate debt. More generally, it has limited discretion when it comes to introducing new instruments. In contrast, Article 20 of the protocol on the statute of the European System of Central Banks and of the ECB specifies that "the Governing Council may, by a majority of two thirds of the vote cast, decide the use upon the use of ... other operational methods of monetary control as it sees fit." The ECB is forbidden from providing credit facilities to public entities and cannot purchase public debt instruments directly in the primary market (Article 21). But no other restrictions are specified.

Third, some conclusions of the ECB's 2003 review need further improvements. This is especially the case for the inflation target. The "below but close to" formulation of the target remains unclear and open to different interpretations even within the Governing Council.² More importantly, the decline in the neutral rate of interest and the binding constraint of the ELB invalidate the assumptions behind the choice of an inflation target near 2 percent, arguing instead for a higher inflation target. In addition, the prominent role for monetary aggregates, which was rightly diminished with the 2003 review, should be eliminated. Other central banks have long since downplayed these indicators in their monetary policy deliberations.

¹ Both the Fed (<https://www.federalreserve.gov/newsevents/pressreleases/monetary20181115a.htm>) and the BoC (<https://www.bankofcanada.ca/2018/11/bank-review-monetary-policy-framework-ahead-2021/>) announced their reviews in late 2018.

² At the February 2014 press conference, ECB President Mario Draghi insisted that the target was symmetric (<https://www.ecb.europa.eu/press/pressconf/2014/html/is140206.en.html>). Yet, in 2019 Bundesbank President said that "the current formulation of the target is not symmetric" in his view (<https://uk.reuters.com/article/uk-germany-ecb-economy/ecbs-weidmann-sees-no-need-for-economic-stimulus-newspaper-idUKKCN1VE0FF>).

Figure 1: Estimates of the Neutral Real Interest Rate



3. SCOPE AND FORMAT OF A REVIEW

The scope of an ECB monetary policy review should be broad. Some components of the framework like the definition of the inflation objective or the articulation of the operating instruments are consequential enough for attaining its goals that they should always be considered as part of a reassessment (Fuhrer et al. 2018). Apart from taking as given its statutory mandate, the review should thus encompass every element of the strategy. This is especially true given the fact that the ECB has not had a review of its policy framework since 2003.

Unfortunately, in its current review, the Fed did not make that choice and took as given that “inflation at a rate of 2 percent is most consistent over the longer run with the congressional mandate” (Clarida 2019). No legal constraints dictated that choice, as the Fed has the authority to define its inflation objective. A better reference point for the ECB are the ongoing reviews by the Bank of Canada and the Swedish Riksbank, which will assess alternative frameworks, the policy toolkit, and the interaction of monetary policy with other public policies.³ For the BoC, it will be the first time since 1991 that a thorough side-by-side comparison of all the main alternatives, including increasing the inflation target, will be done. According to Deputy-Governor Caroline Wilkins (2018), such a thorough review is necessary because it is possible that the current environment of low neutral rates of interest has changed the calculus of their previous assessments on having a higher inflation target (done in 2016) and on following a price-level target (done in 2011).

How often should the ECB reassess its framework? As illustrated with Canada, the frequency question is related to that of the scope. As part of its founding charter, the BoC reviews its monetary policy framework every five years when it renews its inflation-control agreement with the Government. But clearly, the scope varies depending on the extent of the change in economic structures and the profession's understanding of monetary economics. The Federal Reserve's monetary policy strategy was first articulated in 2012 with the adoption of its Statement on Longer-Run Goals and Monetary Policy Strategy. The Fed does not have a regular review process. Yet, the Fed updates this document each January. In its 2016 update, the Fed clarified that its "inflation goal" was a "symmetric inflation goal" and that it "would be concerned if inflation were running persistently above or below this objective."⁴ At his October 2019 press conference, Fed Chair Powell furthermore stated that the Fed likely will conduct future reviews “every few years” so it is reasonable to expect that the Fed will review its strategy periodically every 5 to 10 years. Irrespective of the exact frequency chosen for a regular review, it should allow for an “escape clause” to either re-assess off regular schedule (Fuhrer et al. 2018) or to postpone a regular assessment that appears particularly ill-timed.

Seeking input from stakeholders is also a key part of both the regular five-year reviews of the BoC and the current “Fed Listens” review of the Federal Reserve System, which held 14 events at the Federal Reserve Board and the Reserve Banks in 2019. All citizens are stakeholders, but the best way to gather their views is through various civic organizations such as labour unions, business and trade associations, charitable foundations, state and local government agencies, and community support groups of all types. Views may be solicited both in private meetings and in public conferences that are open to the press. A series of public conferences in all corners of the monetary union can bolster the democratic legitimacy of the review process.

³ See <https://www.bankofcanada.ca/toward-2021-renewing-the-monetary-policy-framework/toward-2021-outreach/>. The scope of the Swedish Riksbank's review, which was announced in December 2016, is even broader as it will also review the Swedish Riksbank Act (<https://www.riksbank.se/en-gb/about-the-riksbank/the-tasks-of-the-riksbank/review-of-the-monetary-policy-framework-and-the-sveriges-riksbank-act/>). This is, however, coherent with the fact that the review was not at the initiative of the central bank but of the government and is carried out by the Swedish Riksdag.

⁴ See <https://www.federalreserve.gov/monetarypolicy/timeline-statement-on-longer-run-goals-and-monetary-policy-strategy.htm>.

Before seeking broad societal input, it is important to define the scope of the review based on inputs from monetary policy experts. Non-experts are not equipped to diagnose the fundamental issues facing monetary policy today. They can be helpful, however, in providing information on societal preferences that should inform the review. For example, most citizens do not understand the mechanism that links a low inflation target to poor economic outcomes. But they typically do have views on unemployment and inflation that can be useful.

In the “Fed Listens” Chicago conference, the message that came through from civic organizations could be characterized as:

Inflation is not now a concern and has not been for a long time. Although lower inflation is better, a modestly higher inflation rate would hardly be noticed. On the other hand, despite record-low unemployment rates, unemployment continues to be a major concern. The strong job market is doing a world of good in bringing people back into the labour force and enabling them to be productive citizens and develop useful skills.

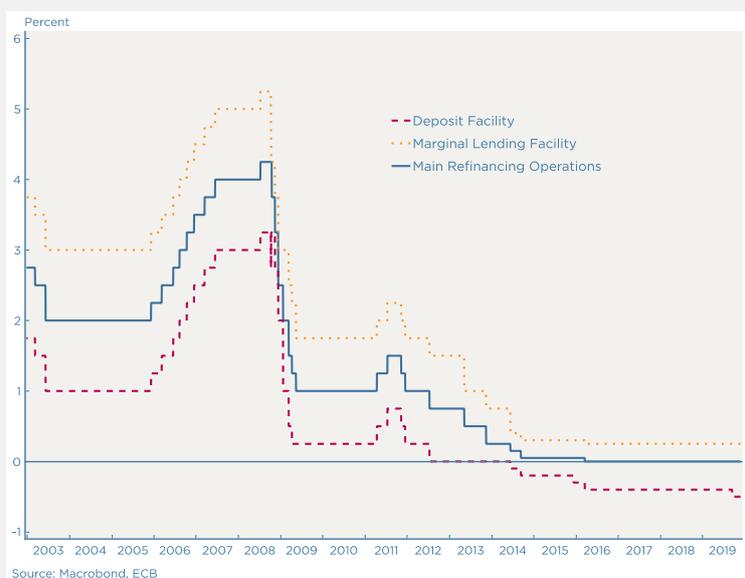
Fed Chair Jerome Powell made similar points about the labour market at his October 2019 press conference. Although boosting employment on a cyclical basis is not a primary goal of the ECB, it is reasonable to argue that a good definition of price stability is one that is consistent with the highest sustainable levels of employment and income.

Box 1: The ZLB, the ELB and the Reversal Rate

As interest rates fall below zero, savers have an incentive to switch from deposits to cash, which has a fixed interest rate of zero. For this reason, the lower bound on nominal interest rates was long held to be zero (ZLB). Yet, it appears that the safety and convenience of digital assets is sufficient to overcome a modest penalty in the form of a negative return.

In fact, policy interest rates have become negative in Sweden, Denmark, Switzerland, Japan and the euro area. Figure 2 shows the three key official ECB rates: the rate on main refinancing operations, which provides the bulk of the liquidity to the financial system; the rate on the deposit facility, for banks that make overnight deposits with the Eurosystem; and the rate on the marginal lending facility, for banks that use overnight credit from the Eurosystem. The deposit rate was brought down to zero in July 2012 and became negative in June 2014. The main refinancing rate was also decreased to zero in March 2016. Today, the marginal lending, the main refinancing, and the deposit rate rates stand respectively at 0.25, 0 and -0.5 percent.

Figure 2: ECB Key Official Rates



Negative rates as low as -0.75 percent (in Switzerland) have not caused a large-scale switch into physical currency. For this reason, the academic literature no longer refers to the lower bound on nominal interest rates as the ZLB but as the effective lower bound (ELB). How much below zero the ELB is remains unclear. The reluctance of central banks to push rates further below current levels may suggest that the ELB is around -100 basis points. Another interpretation is that despite being possible, further decreases in interest rates would not be helpful. In that case, the current rates could be above the technical ELB but would be near what Brunnermeier and Koby (2018) called the “reversal rate,” the rate of interest beyond which further declines become contractionary rather than expansionary.

We define the ELB to be the lowest policy rate that is both feasible and useful to deliver monetary stimulus. We believe that the ECB's policy rates are very close to the ELB.

4. REVIEW PRIORITY 1: REDEFINING PRICE STABILITY

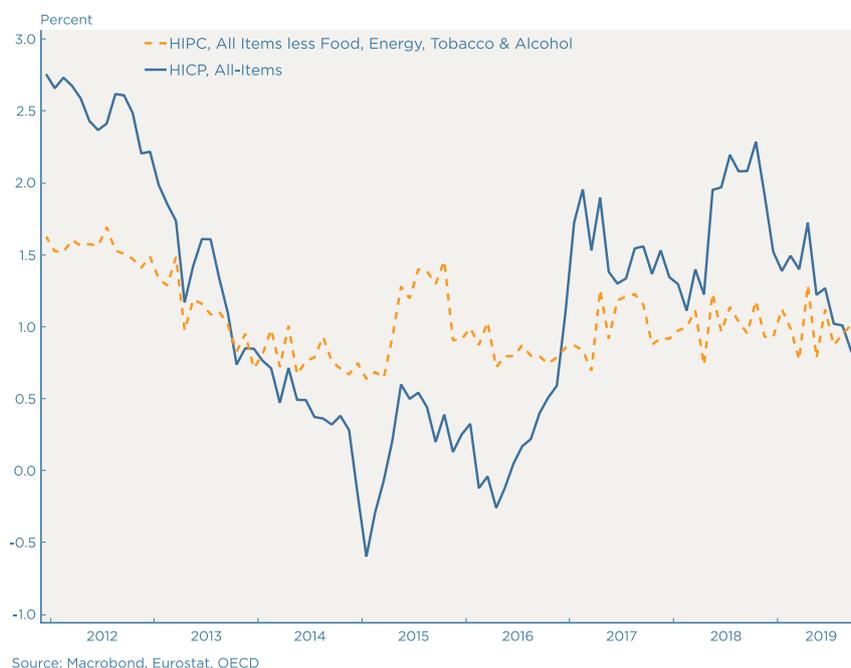
4.1. Background

The ECB has a single primary objective: price stability.⁵ However, the ECB statute does not define price stability. Initially, the Governing Council of the ECB adopted the following definition: “Price stability shall be defined as a year-on-year increase in the Harmonized Index of Consumer Prices for the euro area of below 2 percent” (ECB 1998a).

In its 2003 review, the ECB confirmed this definition but clarified that it will aim to maintain inflation rates below but “close to 2 percent over the medium term” (ECB 2003a).⁶ With this clarification, the Governing Council in effect reduced the set of inflation rates within the 0-2 percent range that it deemed appropriate.

More recently, the symmetry of the aim was clarified. In the February 2014 press conference, ECB President Draghi remarked that the policy aim was symmetric around the level established in 2003. At the March 2016 press conference, the President explicitly clarified that there was no cap on inflation at 2 percent (Draghi 2019). Despite this, many observers and even some members of the Governing Council continue to regard “the current formulation of the target” as “not symmetric.”⁷

Figure 3: Headline and Core CPI Inflation



⁵ See Article 105(1) of the Treaty on European Union https://europa.eu/european-union/sites/europa.eu/files/docs/body/treaty_on_european_union_en.pdf.

⁶ See also <https://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html>.

⁷ See <https://uk.reuters.com/article/uk-germany-ecb-economy/ecbs-weidmann-sees-no-need-for-economic-stimulus-newspaper-idUKKCN1VE0FF>.

Figure 3 shows headline and core inflation in the euro area over the past few years. Since the last review, inflation in the euro area has averaged just below 1 percent, resulting in a cumulative undershoot in the price level of over 6 to 8 percentage points, depending on whether 1.75 or 2 percent is used to operationalize the inflation objective of “close but below 2 percent.” This undershoot is not driven by volatile components in the price index. As already pointed out by ECB President Draghi in its 2019 Sintra speech and illustrated in the figure, core inflation almost declined by a full percentage point from mid-2012 to early 2014 and still hasn't recovered to its pre-crisis average of 1.7 percent.

The costs of low inflation, as described in Box 2, have been far more prominent since 2003 than they were before. In particular, the effective lower bound on interest rates has proved far more damaging than economists believed then. In 2003, ECB President Trichet explained that the Governing Council “took into account studies which have tried to assess the likelihood of nominal interest rates hitting the zero lower bound for various levels of inflation objectives.” At the time, these studies indicated that “the likelihood decreases to very low levels when the central bank aims at an inflation rate above 1%” and thus concluded that “focusing on inflation of below but close to 2% provides a sufficient safety margin.”

In its overview of the background studies for the evolution of the ECB's monetary policy strategy (ECB 2003b), the ECB recognized that, even then, some studies found that the risks of hitting the ZLB remain non-negligible for rates of inflation above 1%. But it concluded that these studies should be “taken with particular caution [because] they are frequently based on the assumption that the equilibrium [real interest] rate stands at 2%, which seems to be at the lower end of plausible figures.” With the benefit of hindsight, we now know that this assumption was at the upper end rather than at the lower end of plausible figures.

The experience suggests that the ECB's definition of price stability has not only hampered the achievement of the secondary objectives, such as high employment, but has also prevented the ECB from easing monetary conditions enough to keep inflation close to 2 percent.

4.2. Recommendation

The ECB should redefine price stability as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area close to 3%. This recommendation is motivated in part by the secular decline in the neutral rate of interest, which changes the calculus of the inflation target. If an inflation rate of close to 2 percent was considered optimal in 2003, it follows that a higher rate must be considered optimal now given the decrease in the neutral real interest rate.

Simulations in Andrade et al. (2019) show that a 100 basis point drop in the neutral rate of interest almost doubles the probability of hitting the ELB if the monetary authority keeps its inflation target unchanged. Using a different model, Wilkins (2018) finds that this probability has increased in Canada to 13 percent instead of about 3 percent when the neutral rate was higher.

The optimal reaction is to increase the inflation target one-for-one with the estimated decrease in the neutral rate of interest (Andrade et al. 2019). The target for inflation should thus be raised from just below 2 percent to around 3 percent. Given the confusion created by the “below but close to” language, the target should be symmetrically around 3 percent, rather than symmetric around a level below but close to 3 percent.

Box 2: The Costs of Very Low Inflation

The conventional view is that stable low inflation reduces uncertainty and improves the price-formation process, thereby maximizing long-run income and employment. However, downward wage and price rigidity tend to raise unemployment permanently as inflation becomes very low because workers resist nominal pay cuts much more than they resist real pay cuts through inflation. Low inflation also increases the time interest rates are constrained by their effective lower bound, preventing central banks from stabilizing the economy in the face of negative shocks.

In the standard linear accelerationist Phillips curve model, any constant inflation rate will allow unemployment to return to its natural rate. There are no gains to be had from permanent shifts in the inflation rate and there is no reason not to choose a very low inflation target. However, with very low target inflation and downward wage and price rigidity, the Phillips curve becomes nonlinear; it is flat at high rates of unemployment (Gagnon and Collins 2019a). This flattening occurs even when average wage increases are positive, because there are always some workers facing below-average wage increases. As overall wage inflation declines, more and more workers face potential wage cuts, and many of them prefer to risk unemployment than to accept a nominal wage cut. Thus, it takes a high rate of unemployment to enable overall wage inflation to be close to zero.

Unemployment can remain far above the natural rate for years at a time with a constant low rate of inflation. Failure to allow for a nonlinear Phillips curve leads many economists (including staff at the European Commission and other international institutions) to overestimate the natural rate of unemployment because their models assume that any unemployment rate with stable inflation must be the natural rate (Cohen-Setton and Valla 2010; Brooks and Basile 2019). In fact, downward wage rigidity makes output gaps negative on average when inflation is very low (Aiyar and Voigts 2019). By generating a policy stance that is too tight compared to what would be optimal, the overestimation of the natural unemployment rate creates a massive loss of economic welfare. Raising the inflation target would remove some of these problems and thus permanently reduce the unemployment rate.

Low target inflation also increases the risk of having interest rates constrained by the ELB, preventing the central bank from steering the economy to full employment. The Governing Council notes the importance of providing “an adequate margin to reduce the risks of deflation ... because there are limits to how far interest rates can be cut ... this makes it more difficult for monetary policy to fight deflation than to fight inflation.” An important factor increasing the frequency of lower bound episodes is the secular decline in the equilibrium real interest rate. Andrade et al. (2019) show that a falling equilibrium real interest rate (r^*) increases the risk of hitting the ELB and that the optimal policy response is to raise the inflation target nearly one for one with any fall in r^* .

If the current target is taken as 1.75 percent, an increase to 3 percent would eventually cause interest rates to rise 1.25 percent at all maturities. The ECB would have 1.25 percentage points more scope to reduce its policy rate in a recession. However, the total increase in policy space is much larger than that. A higher starting point for bond yields means more scope to use the asset purchase program (APP) to reduce bond yields. The total increase in policy scope from a 1.25 percentage point increase in the

inflation target is equivalent to 3 percentage points of room to cut the policy rate (Gagnon and Collins 2019b).

To elaborate, the scope for a central bank to fight a recession is related to the distance of nominal interest rates of all maturities from the ELB. So, if the central bank were to raise the inflation target, and the market believed in the central bank's desire and ability to achieve this higher rate of inflation, expected inflation and nominal interest rates of all maturities would rise by the amount of the increase in the inflation target.

Raising the inflation target by 1.25 percentage points would raise all interest rates by 1.25 percentage points, giving the ECB 1.25 percentage points more room to cut its policy rate. And it would also increase the scope to cut longer-term rates. According to the Federal Reserve's model for the US economy, each 1.25 percentage point cut in the short-term policy rate reduces the interest rate on the 10-year government bond about 0.5 percentage point. After a 1.25 percentage point policy rate cut, the bond yield would remain 0.75 percentage point higher than it was before the increase in the inflation target. The ECB would be able to use forward guidance and the APP to push bond yields to their ELB. The stimulative impact of these measures is equivalent to an additional 1.75 percentage point cut in the policy rate for a total stimulus equivalent to a 3 percentage point reduction in the policy rate (Gagnon and Collins 2019b).

Finally, the ECB should redefine price stability to mean a higher rate of inflation to better support its stated commitment to "provide a sufficient margin to address the implications of differences in inflation across the euro area countries. In this way the inflation aim helps to prevent some countries or regions having to live with excessively low or even negative inflation rates while other countries experience higher inflation rates." Asymmetric shocks have also proved far more damaging than economists believed in 2003. Given the need for differentiated country inflation rates that these asymmetric shocks create, a higher inflation target would increase the margin for adjustment, making the rebalancing process within the euro area smoother.

Most citizens would hardly notice the difference between 2 percent and 3 percent inflation. In the 30 years before the euro, German inflation averaged 3.5 percent and the Bundesbank was widely admired for delivering price stability. In the present circumstances, an immediate increase in the inflation target is hardly credible and the ECB should not make any claims about achieving it soon. However, the ECB should explain how and why it plans to work toward this goal over the medium term.

Box 3: Inflation Makeup Strategies

Most central banks currently formulate their inflation objective with no reference to how past inflation has behaved (an exception is the Reserve Bank of Australia, whose inflation goal is specified as a range of "2–3 per cent, on average, over time"). Instead, the aim is to achieve a specific rate of inflation by some time horizon. Under this formulation, the central bank lets "bygones be bygones." It does not try to compensate past inflation shortfalls with future inflation overshoots.

Several "makeup strategies", in which past realisation of inflation below the objective gives rise to policy actions designed to deliver inflation above the objective, have received considerable attention in recent years. A detailed and comprehensive review of the different makeup strategies currently debated is beyond the scope of this paper. But they include average inflation targeting, where policymakers seek to keep the average rate of inflation close to the target rate over some specified time period. They also include price-level targeting (PLT) or nominal income targeting (NIT), in which policymakers try to stabilise the price level or nominal income around a constant growth path.

Some other makeup strategies seek to reverse shortfalls in policy accommodation at the ELB by keeping the policy rate lower for longer (LFL) than otherwise would be the case. LFL strategies can be formulated in terms of inflation and employment thresholds, in terms of the cumulative shortfall of conventional policy accommodation associated with the ELB, or as a temporary PLT or temporary NIT. One advantage of some LFL strategies is that they would not amount to a significant change in the ECB's reaction function in normal times. They need not change the targeted level of inflation over the long run and would not require that the effects of supply shocks that temporarily drive up inflation be reversed.

The effectiveness of these approaches, however, relies heavily on the forward-looking behaviour of private agents. Simulations of the Fed's workhorse econometric model of the US economy also suggest that to deliver more than modest gains compared to the current framework, these strategies demand that interest rates be kept low for a very long time, raising credibility questions about future policymakers' commitment to follow through with the strategy (Reifschneider and Wilcox 2019a).

5. REVIEW PRIORITY 2: EXPANDING THE SET OF INSTRUMENTS

5.1. Background

The credibility of the ECB does not rely solely on perceptions of its commitment towards delivering its inflation aim, but also on perceptions of its capability to attain that aim. At the current juncture, both short-term and longer-term safe interest rates are constrained by the ELB. At the time of this writing (19 November 2019), German government bonds have negative yields across the maturity spectrum, including -0.38 percent on 10-year bonds. 10-year yield bonds are also negative in the Netherlands (-0.20 percent) and France (-0.03). In Spain, Italy, and Greece, they respectively stand at 0.42, 1.23 and 1.4 percent.

Gagnon and Collins (2019b) estimate that reducing all members' bond yields to the level of Germany would lower the weighted average bond yield in the euro area by 0.4 percentage points. At most, they estimate that this would provide stimulus equivalent to a policy rate cut of less than 1 percentage point. It is not clear if even this modest degree of policy ease is feasible. First, because the ECB currently purchases government bonds in proportion to its capital key. Second, because it also limits its purchases to 33 percent of any individual bond and 25 percent of any bond with a collective action clause to avoid having the ability to veto a debt restructuring. Failure to block a restructuring could be viewed as monetary financing.

In his 24 October press conference, President Draghi emphasized that these constraints are self-imposed.⁸ They could be modified or even entirely lifted.⁹ Even under an optimistic view of the ECB's ability to reduce spreads in bond yields in peripheral countries, the effective stimulus available through that route is far less than would be required to combat a new recession (Gagnon and Collins 2019b; Pisani-Ferry 2019). The current framework is not likely to keep inflation near target when the next downturn occurs.

5.2. Recommendation

The review should discuss the extent to which use of its current tools could be extended without facing legal constraints. It should also describe which additional tools could be introduced for the ECB to achieve its objective.

Having a credible contingency plan and describing how the current set of tools could be used to provide further stimulus would correspond to what the BoC did in its 2016 review. Another precedent is the speech given by ECB President Draghi in April 2014 when possible additional tools to counteract downside inflation risks were discussed. As argued in his 2019 Sintra speech, this contingency planning "established unambiguously that [the ECB] had no taboos about resorting to unconventional measures." The minutes of the 29-30 October Federal Open Market Committee meeting reveal that "several participants suggested that communicating to the public clearly and convincingly in advance about how the Committee intended to provide accommodation at the ELB would enhance public confidence and support the effectiveness of whichever tool the Committee selected."¹⁰

The current set of instruments works by lowering interest rates on government debt. The ECB could also consider purchasing risky assets to decrease the risk premium. Given the small size of the low-rated corporate bond market in Europe, the ECB would have to operate in the corporate equity market, the

⁸ <https://www.ecb.europa.eu/press/pressconf/2019/html/ecb.is191024~78a5550bc1.en.html>.

⁹ Whelan (2019) believes that the issuer limit could be raised to just below 50 percent, based on the OMT ruling by the European Court of Justice that the ECB would be treated the same as other creditors in case of a restructuring.

¹⁰ <https://www.federalreserve.gov/monetarypolicy/fomcminutes20191030.htm>.

real estate investment trust market, or establish a program for subsidised mortgage lending. There is no upper bound on equity and real-estate prices and thus no apparent limit to how much stimulus could be applied in that manner.

Other measures that go beyond the interest rate channel like outright transfers to the general public – or what is often referred to as helicopter money (HM) – could also be considered. In March 2016, ECB President Draghi called it “an interesting concept” and ECB Board Member Peter Praet noted that “central banks can do it.” According to Praet, “the question is, if and when it is opportune to make recourse to that sort of instrument which is really an extreme sort of instrument.”¹¹ Many observers, including former central bankers like Stanley Fischer, have recommended that direct transfers be explored for future use, for example through a “standing emergency fiscal facility” (Bartsch et al. 2019).

Some observers, like Blanchard and Pisani-Ferry (2019), caution against the use of HM in the euro area because of questions about how the transfers would be distributed across countries and across people. As argued by *The Economist*, one simple option would be a uniform handout in which every legal euro area resident would receive an equal share of newly created money.¹² In light of concerns that the APP has benefited wealthy households disproportionately, HM might be viewed as a distinct improvement over the APP (Muellbauer 2014).

The question of how to do the transfers is, however, more daunting. As argued by both Blanchard and Pisani-Ferry (2019) and Whelan (2019), the ECB does not have a register of everyone living in the euro area. It thus does not have (for now) the capacity to deliver transfers to the public directly.

One option would be for the ECB to use the names and addresses from electoral rolls. This would, however, exclude unregistered voters as recipient. Another option would be to identify all households who pay payroll taxes, income taxes and/or receive transfers. But this would require close cooperation with fiscal authorities. A third option would be to distribute the transfers through banks. Under this mechanism, citizens would apply to banks for their transfers, banks would review the customer documents and pass the information on to ECB, which would credit each approved citizen’s account. This would require that banks open account for those citizens without bank accounts who are applying for the transfer, that banks be compensated for the administrative cost associated with the measure, and that they provide the ECB with sufficient information to prevent citizens from claiming their transfer more than once.

To prevent abuse and ensure a commitment to not overdo it, Gagnon (2019) proposes that transfers only be made only when interest rates are constrained by the ELB, when employment and inflation are falling short of their objectives, and according to a formula set in advance by elected representatives. Bartsch et al. (2019) suggests similar safeguards that would limit the use of this policy instrument to unusual situations. In the US context, Gagnon (2019) proposes that transfers be contingent on the approval of the Secretary of the Treasury. In the absence of a central fiscal authority, this last condition would not translate well to the European context. Yet it is that same difficulty of implementing a common fiscal policy response which reinforces the case for strengthening the monetary policy framework as a matter of prudent planning and makes having that power lodged at the ECB attractive.

One should also note that when central banks have already set interest rates below zero across the curve, HM improves the fiscal balance directly (or at worst does not harm it if the additional bank reserves are paid 0 interest, but probably some of the increase should be in reserves at negative interest

¹¹ See <https://www.ecb.europa.eu/press/pressconf/2016/html/is160310.en.html> and <https://www.ecb.europa.eu/press/inter/date/2016/html/sp160318.en.html>.

¹² <https://www.economist.com/special-report/2019/10/10/how-to-make-economic-policy-fit-for-a-world-of-low-inflation>.

rate or even in ECB marketable bills at negative rate). When higher tax revenues from higher GDP are factored in, the improvement in fiscal balances associated with HM is overwhelming.

Altogether, these obstacles most likely make HM today difficult. But improving clarity about the ECB's toolkit in case of a recession in a low neutral rate environment is a necessary step forward. While controversial, HM should be among the tools explored to provide observers with clarity regarding whether and how quickly the difficulties described above can be overcome.

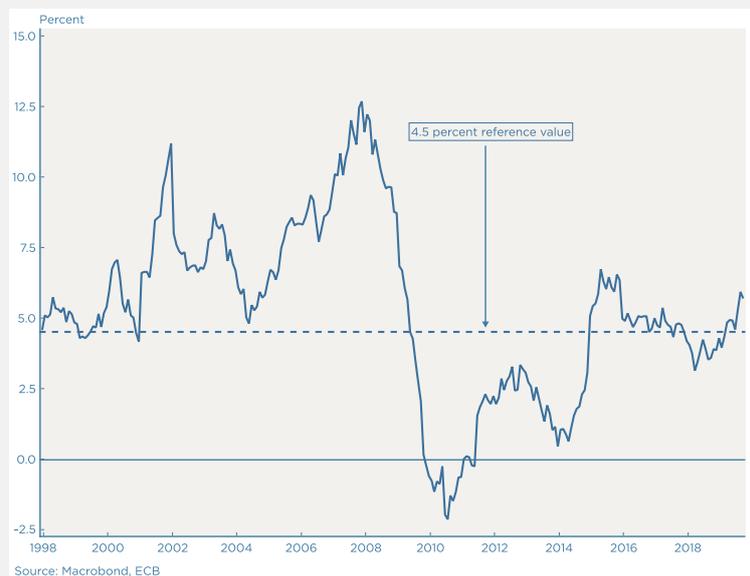
Box 4: The Two-Pillar Strategy and Monetary Aggregates

Already in the initial formulation of its strategy in October 1998, the ECB singled out money from the set of selected key indicators that it monitors (Trichet 2003). A prominent role for money with a reference value for the growth of a monetary aggregate would ensure that “the central bank ... does not lose sight of the fact that over a sufficiently extended horizon the rate of growth of money must be consistent with the price stability objective” (ECB 2003a). In the so-called two pillar strategy, the “broadly-based assessment of the outlook for price developments” (first pillar) would be complemented by “the analysis of monetary growth in relation to [a] reference value” (second pillar), with the understanding that deviations from “the reference value would, in normal circumstances, signal risks to price stability” (ECB 1998a).

In December 1998, it was agreed that the monetary aggregate M3 would be used and that the reference value would be set at 4.5 percent. Underlying this choice was the view that the trend growth rate of real GDP was in the range of 2 percent to 2.5 percent per year, that the medium-trend in velocity is a decline between 0.5 percent and 1 percent per year, and that inflation is in the long run a monetary phenomenon. Accordingly, since $\Delta M + \Delta V = \Delta P + \Delta Y$, a reference value of 4.5 percent would be consistent with the definition of price stability of “below 2 percent.”

The May 2003 strategy review downgraded the importance of the monetary pillar (ECB 2003a) by codifying that the analysis under the economic pillar would come first in the introductory statement of the President and that the analysis under the monetary pillar “mainly serves as a means of cross-checking ... [the] economic analysis.”

Figure 4: M3 Reference Value and Growth Rate



In 2000, the Federal Reserve chose to discontinue setting targets for broad monetary aggregates (Bernanke 2006) in view of the instability of money demand and their poor leading properties with respect to price developments. Figure 4 illustrates that the European experience with monetary aggregates has not been better than in the US. Growth well in excess of the reference value of 4.5 percent in the 2000s was not, for example, associated with large price increases. We recommend that the ECB follows other central banks that have long since downplayed monetary aggregates in their monetary policy deliberations.

6. QUESTIONS FOR MEPS

- The Bank of Canada and the Federal Reserve System are considering strategies that make up for past inflation misses during sustained periods of below-target inflation. Should the ECB review consider such “make-up” strategies?
- The Fed has ruled out raising its inflation target in the current review but the Bank of Canada and the Swedish Riksbank have not. Should the ECB review consider changing the level of its inflation objective?
- The ECB has more scope than most central banks to introduce new instruments. Should the strategy review explore a new set of unconventional policy tools that might be needed to fight the next recession? Should these tools include purchases of risky assets such as equity and real estate?
- Should the ECB consider outright transfers to households or what is often referred to as helicopter money as a possible new instrument that could be introduced?
- In 2000, the Fed chose to discontinue setting targets for broad monetary aggregates in view of their poor leading properties with respect to price developments. Should the ECB retain its two-pillar strategy with an elevated status for monetary aggregates among the set of key indicators that it monitors?

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Lower neutral rates of interest have eroded the policy space necessary to fight recessions. Against this backdrop, several central banks are re-assessing how their strategy and tools can be refined to best achieve their goals. The ECB should be no exception. Its strategy review should focus on redefining the inflation objective and on developing contingency plans for using its statutory authority creatively to achieve its mandate.

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