Number and prioritization of central bank objectives

Eijffinger, S.C.W.

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Number and Prioritization of Central Bank Objectives

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Executive Summary

The Treaty has made the European Central Bank (ECB) very independent. Nowadays is it widely believed that a high level of central bank independence and an explicit mandate for the bank to restrain inflation are important institutional devices to assure price stability. It is thought that an independent central bank can give full priority to low levels of inflation. In countries with a more dependent central bank other considerations (notably, re-election perspectives of politicians and a low level of unemployment) may interfere with the objective of price stability. Recent empirical research on central bank independence has also shown that the negative relationship between central bank independence and inflation is quite robust. Before the ECB started its operations, the main elements of its monetary policy had been decided upon by the Governing Council in October 1998. The original strategy consisted of three elements. First, the Council provided a formal definition of price stability, i.e. yearly inflation for the euro area of less than two percent in the medium term. Second, money growth was assigned a prominent role in the assessment of the risks to price stability. This was known as the first pillar of the ECB's monetary policy. Third, a broadly based evaluation of the threat to price stability, using a wide array of economic and financial variables. This was the second pillar. In May 2003 the ECB announced the outcomes of its internal evaluation of this strategy. Even though the ECB stressed the continuity of its strategy and stated that the decisions taken were merely about clarification, these decisions have been widely interepreted as a change in the ECB's monetary policy strategy. The ECB will seek to maintain the inflation rate below, but close to, 2 per cent over the medium term. The Council confirmed the use of the two-pillar framework of the strategy as a tool to organise the information relevant for assessing the different risks to price stability. It also announced that the introductory statement of the President at the ECB Press Conference following a Governing Council rate-setting meeting now starts with an analysis identifying the short- to medium-term risks to price stability. This assessment has been called the economic analysis. It is followed by an assessment of the medium- to long-term risks to price stability, focusing on monetary indicators. This assessment has been called the monetary analysis. The Governing Council emphasised that the monetary analysis serves mainly as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications from the economic analysis. This decision has been widely interpreted as the downgrading of importance of the (previous) first pillar.

Introduction

The purpose of this Briefing Paper is to discuss the number and prioritization of central bank objectives[1]. Article 105.1 of the Treaty establishing the European Community (TEC) states price stability as the primary objective of the European System of Central Banks (ESCB) or the Eurosystem. At the same time this is not the sole objective mentioned as the second sentence of this article states: "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2." Supporters of a stabilization role of monetary policy interpret the second sentence of Article 105.1 in the sense of a duty to follow employment policies in times of price stability. However, opponents of such a role will deny this room to manoeuvre.

The Treaty has made the European Central Bank (ECB) very independent. Nowadays is it widely believed that a high level of central bank independence and an explicit mandate for the bank to restrain inflation are important institutional devices to assure price stability (Eijffinger and De Haan, 1996). It is thought that an independent central bank can give full priority to low levels of inflation. In countries with a more dependent central bank other considerations (notably, re-election perspectives of politicians and a low level of unemployment) may interfere with the objective of price stability. In that context the Ger- >

man central bank is often mentioned as an example. The Deutsche Bundesbank was relatively autonomous; at the same time, Germany had one of the best post-Second World War inflation records among the OECD countries. Indeed, the statutes of the ECB are largely modeled after the law governing the Bundesbank. Recent empirical research on central bank independence has also shown that the negative relationship between central bank independence and inflation is quite robust
(see also: Berger et al., 2001).

The monetary policy strategy of the ECB has three main elements: (1) a quantitative definition of price stability, (2) a prominent role for money in the assessment of risks to price stability, and (3) a broadly based assessment of the outlook for price developments. In December 2002 the ECB Governing Council decided to evaluate this strategy in the light of the experience, taking into account the public debate and the outcomes of research undertaken by staff of the Eurosystem. The results of this evaluation were published in May 2003, which we will discuss later in this Briefing Paper.

▲ *Prof. Dr. Sylvester C. W. Eijffinger - CentER Tilburg University, RSM Erasmus University and CEPR*

Monetary policy strategy of the ECB

The primary objective of the ESCB is price stability. However, the Treaty does not provide a specific definition of this objective. In October 1998 the Governing Council of the ECB defined price stability as follows: a year-on-year increase of the Harmonized Index of Consumer Prices (HICP) for the euro area, which does not exceed 2 per cent in the medium term. Issing et al. (2001) point out that this quantification is in agreement with the stated preferences of European governments as expressed several times in the European Council's Broad Economic Guidelines.

The HICP is a comprehensive measure for inflation, reflecting the focus of the general public on consumer goods[2]. The aim of an inflation rate "below 2 per cent" clearly delineates the maximum rate of inflation deemed to be consistent with price stability. The wording "year-on-year increases" implies that persistent price decreases - that is to say deflation in the measured price index - would not be considered to be consistent with price stability either. The Governing Council explicitly announced that price stability is to be maintained over the medium term, thereby acknowledging that price levels may be temporarily distorted by short-term factors.

The wording "for the euro area" highlights that area-wide developments, instead of specific national or regional factors, are the only determinants of decisions regarding the single monetary policy. A year-on-year increase of the HICP for the euro area as a whole represents price stability, even if increases in national price indices are above 2 per cent per year.

At the time the monetary policy strategy of the ECB was introduced, it rested on two "pillars". The first pillar is a prominent role for money. As inflation in the long run is considered to be a monetary phenomenon, the ECB Governing Council has announced a quantitative reference value for the annual growth rate of a broad monetary aggregate (M3). The focus on M3 is justified, according to the ECB (2001), by its favorable empirical properties like a stable money demand relationship. Furthermore, M3 has shown to exhibit leading indicator properties for future inflation (see also Issing et al., 2001). The reference value for M3 growth, which was set at 4.5%, should however not be considered as intermediate monetary target, "in order to avoid an automatic monetary policy reaction to fluctuations in M3 growth that may not be associated with inflationary pressures, but that may result, for example, from .... financial innovations" (Issing, 1999, p. 20). Although the first pillar is sometimes presented as only referring to M3 growth (see e.g. Begg et al., 2000), the ECB examines not only to what extent M3 growth deviates from the reference value, but analyzes underlying causes as well. Quite some attention is being paid, for instance, to the growth rates of the components of M3, notably the growth rate of credit supplied to the private sector.

The second pillar is a broadly based assessment both of the outlook regarding price developments and of the risks to price stability in the euro area as a whole. A wide range of economic and financial indicator variables is used for this purpose, which can be grouped in (a) gap measures (i.e. measures of the discrepancy between output, or its factors of production, and their equilibrium values); (b) measures of cost pressure; (c) international prices and exchange rates; and (d) other asset prices (see Issing et al., 2001). The indicators include:

- the HICP and other price indicators in the euro area, including producer prices as these are a leading indicator for HICP inflation. In addition, price developments in the world markets for raw materials are closely monitored, especially, of course, the price of crude oil. Oil prices have a clear impact on inflation in the euro area. The ECB also analyses the deflator of the euro area's Gross Domestic Product (GDP), as well as the deflators of its components. Finally, the ECB keeps an eye on real estate prices, where possible.
- indicators for the real sector. The ECB monitors real GDP and its components, and also the production of the manufacturing and other sectors. The capacity utilization rate also belongs to this category >

of indicators.

- confidence indicators, including the economic sentiment indicator and various consumers and business sectors confidence indicators.
- indicators for the labor market. Employment and unemployment in the whole economy and by sector, as well as wages and unit labor costs (total and its components) and productivity belong to this category.
- exchange rates. The euro-dollar exchange rate, but also (real and nominal) effective exchange rates are closely monitored by the ECB. The initial decline of the euro vis-à-vis the dollar has had quite some impact on inflation in the euro area.
- financial market indicators. To this group of indicators belong various interest rates, as well as the term structure and stock market indices. The long-term yield and the term structure are often considered to contain information concerning (expectations of) future inflation and economic growth.
- projections for inflation and economic activity. The Governing Council also takes forecasts by others - like the Consensus forecasts - as well as the projections of the staff of the ECB into account in its decision-making process

The ECB's evaluation of its monetary policy strategy

On 8 May 2003 the Governing Council of the ECB made the results of the evaluation of its monetary policy strategy public. The Council considered that, so far, the strategy worked satisfactorily. As Issing (2003, pp. 4-5) put it:

"Since 1999, medium and long-term inflation expectations - as measured by survey data or financial market indicators - have remained consistent with the ECB's definition of price stability. This is all the more remarkable given that the ECB started without a track record of its own and that it has experienced a number of sizeable adverse price shocks. As a result of these shocks, HICP inflation was above (and sometimes significantly above) 2% for quite some time. But, as the shocks gradually unwound, so inflation has returned towards levels compatible with price stability. Medium and long-term inflation expectations remained well anchored throughout this period."

Still, the Council took two decisions in view of the evaluation. First, the Governing Council confirmed its definition of price stability. At the same time, the Governing Council agreed that it will aim to maintain inflation rates close to 2 per cent over the medium term. According to the ECB press release, "This clarification underlines the ECB's commitment to provide a sufficient safety margin to guard against the risks of deflation. It also addresses the issue of the possible presence of a measurement bias in the HICP and the implications of inflation differentials within the euro area."
As pointed out by Issing (2003), an important reason to aim at an inflation close to 2 per cent is the need for a safety margin against potential risks of deflation. In case of strong deflationary pressures, monetary policy may become less effective if central bank interest rate management is constrained by a liquidity trap or a "zero bound" problem. According to analyses of the ECB, such constraints should not pose a significant threat if inflation remains sufficiently above zero. To aim at inflation rates close to 2 per cent offers a safeguard in this respect. At the same time, it takes into account both the potential presence of a measurement bias in the HICP and the implications of inflation differentials of a structural nature within the euro area.

Second, the Council decided that its policy decisions will continue to be based on "a comprehensive analysis of the risks to price stability". The Council noted that, over time, the analysis under both pillars of the monetary policy strategy has been deepened and extended. However, in order to "clarify communication on the cross-checking of information in coming to its unified overall judgement on the risks to price stability", the introductory statement of the President has henceforth followed a new structure. It starts with the economic analysis to "identify short to medium-term risks to price stability", followed by the monetary analysis "to assess medium to long-term trends in inflation in view of the close relationship between money and prices over extended horizons." As in the past, monetary analysis takes into account developments in a wide range of monetary indicators including M3, its components and counterparts, notably credit, and various measures of excess liquidity. According to the Governing Council, the monetary analysis serves mainly as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications from the economic analysis. To underscore the longer-term nature of the reference value for monetary growth, the Governing Council decided to discontinue the practice of an annual review of the reference value for M3 growth.

Even though it was supposed to be a clarification of its objective of price stability, many observers have interpreted the statements of the ECB on price stability as a change in its inflation objective. For instance, Sibert (2003) argues that: "This presentational slight of hand should fool no one; this is a distinctly dovish change in policy. When it was originally announced that inflation was to be kept at less than two percent, the natural interpretation was not that the ECB was aiming to keep inflation just below two percent. Given the floor of zero, the obvious interpretation was that the ECB was aiming for about one percent and viewed the costs of deviating from this as rising sharply as inflation either rose to two percent or fell to zero percent."
Likewise, the decision on the two-pillar strategy has been widely interpreted as implying that the first pillar has become less important in the monetary strategy, even though ECB officials stressed the continuity of the strategy. Svensson (2003) summarizes the Governing Council decision as follows: "Keeping the two-pillar strategy but reducing the prominence of the first pillar by putting it second and discussing the >

monetary pillar (relabeled "monetary analysis") after the "broadly-based assessment" (relabeled "economic analysis"), seeing it mainly as a means of "cross-checking" the "economic analysis". This is a change in the right direction, but it is not enough."

Similarly, De Grauwe (2003) states: "the ECB is downgrading the importance of the money stock (M3) in its monetary policy strategy, and rightly so. It just did not make sense anymore to pretend that the money stock is the most important variable to watch. This variable is so much polluted by noise that it rarely gave the right warning signal of future inflation."

Conclusions

The Treaty has made the European Central Bank (ECB) very independent. Nowadays is it widely believed that a high level of central bank independence and an explicit mandate for the bank to restrain inflation are important institutional devices to assure price stability. It is thought that an independent central bank can give full priority to low levels of inflation. In countries with a more dependent central bank other considerations (notably, re-election perspectives of politicians and a low level of unemployment) may interfere with the objective of price stability. Recent empirical research on central bank independence has also shown that the negative relationship between central bank independence and inflation is quite robust.

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1 This Briefing Paper draws heavily on Chapter 2 of De Haan, Eijffinger and Waller (2005).

2 The HICP has the following main characteristics: it encompasses only market transactions, is does not include interest rates, owner occupied housing is at present excluded, expenditure incurred for business purposes is excluded, it includes the consumption expenditure of foreigners in the reference country, but excludes the consumption of residents abroad (see Camba-Mendez et al., 2002 for further details).