The New Euro Area Inflation

The Right Reset?

- Useful changes to the monetary policy framework, but:
  -

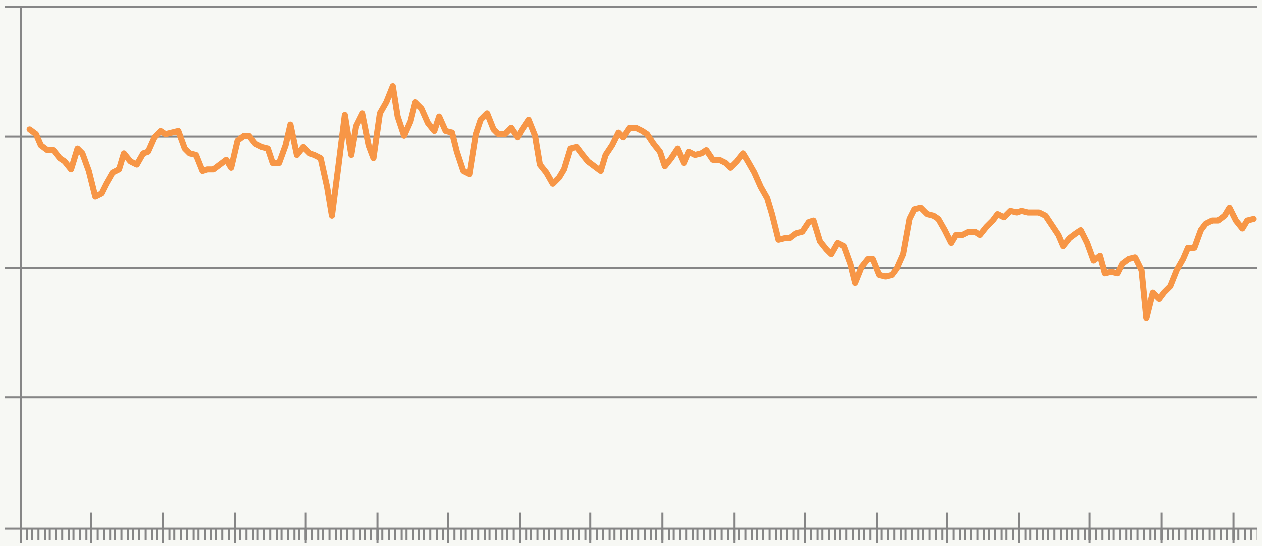
ECB staff macroeconomic projections for euro-

The previous inflation objective of the ECB

- 1998: *"Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%."*
- *"The Governing Council clarified in 2003 that in the pursuit of price stability it aims to maintain inflation rates below, but close to, 2% over the medium term."*

- This dual determination of the objective was unique
- This objective might have been perceived as asymmetric, resulting in more forceful monetary actions in case inflation overshot 2% than when inflation fell short of 2%. But: see next slide

Both actual inflation and expected long-term inflation were close to 2% in 2003-2014 …



Source: Bloomberg

July 2021: The new ECB inflation target and indicator

- **<u>Target:</u>** "*The Governing Council considers that price stability is best maintained by aiming for two per cent inflation over the medium term. The Governing Council's commitment to this target is symmetric. Symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable.*"

- **<u>Indicator</u>**: "*The Governing Council confirms that the Harmonised Index of Consumer Prices (HICP) remains the appropriate price measure for assessing the achievement of the price stability objective. However, the Governing Council recognises that the inclusion of the costs related to owner-occupied housing in the HICP would better represent the inflation rate that is relevant for households.*"

Comparison of inflation targets and indicators of four central banks

The inflation target adopted by the Federal Reserve in 2020

- *"In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."*
- Justification:
  - *"Inflation averaging less than 2 percent over time can lead to an unwelcome fall in longer-term inflation expectations, which in turn can pull actual inflation lower, resulting in an adverse cycle of lower inflation and inflation expectations."*
  - *"With lower expected inflation, the nominal level of interest rates will be lower too, leaving less room for the FOMC to cut interest rates when needed to support the economy in a downturn."*
  - *"By seeking inflation that averages 2 percent over time this will help ensure longer-run inflation expectations do not drift down and remain well anchored at 2 percent."*

The ECB Governing Council did not justify reasons for <u>not</u> opting for average inflation targeting (AIT)

- <u>ECB staff research</u>: Credible AIT lessen negative biases in inflation and economic activity, and also reduce macro volatility. However, "*The effectiveness … hinges on the degree*
  - *to which they are credible and well understood by the private sector,*
  - *the extent to which private sector expectations are forward-looking and stable, and*
  - *the consistency of private sector economic behaviour*"
- When these conditions are not met, AIT brings less benefits and not superior to simple IT
- Yet some findings can be sensitive to the modelling framework
- ECB modellers persistently failed to forecast inflation in the past decade, undermining the trust in those models

Medium-term remains unclear, as well as its interaction with financial stability concerns

- 2003 Strategy Review: the medium-term horizon was justified to allow for monetary transmission and the ECB to adapt its reactions to different types of shocks
- 2021 Strategy Review – additional reasoning: "*deviation of inflation from the target is context-specific*" and "*to cater for other considerations*
  0 G[(m0 4 re.0000160m704o0b00 0 1B()8(m0.2 Tm0 g0 G-0(a00 0 Tm0-3)>BD( )-2

Exercise deriving an owner-

Main messages

- Changing the previous ambiguous inflation aim to a well-defined target should facilitate a better understanding of ECB intentions
- Yet no clear demonstration of the previous ambiguous aim contributing to the ECB's forecasting failure and the fall in inflationary expectations since 2014
- Structural challenges (reduced real interest rate, demographic changes, uncertain Phillips-curve parameters) remain, as well as dependence on luck
- No clear understanding of the ECB choice

Thank you for your attention!