

INFLATION TARGETING

The First Year of the Eurosystem: Inflation Targeting or Not?

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On 1 January 1999, the Euro was launched, and the Eurosystem (the European Central Bank [ECB] and 11 national central banks in Europe) took responsibility for monetary policy in the Euro area. This paper is a brief evaluation of the Eurosystem's monetary-policy regime after its first year, in particular of the extent to which it is similar to inflation targeting as practiced by an increasing number of central banks.¹ I examine three elements of the Eurosystem, namely, the goals, the framework for monetary-policy decisions, and the communication with outsiders. Criteria for evaluation are whether the goals are unambiguous and appropriate; whether the decision framework is efficient in collecting and processing information and reaching decisions that are appropriate relative to the goals; and whether the communication is effective in motivating decisions, simplifying external evaluation, and thereby improving transparency and accountability. I also consider whether the actual instrument setting has been appropriate, given the information available at the times of decision.

During the 1990's an increasing number of central banks adopted inflation targeting, which due to its logical and transparent design and apparent success so far has become a focus of interest and a natural frame of reference. Inflation targeting is characterized by, first, an explicit numerical inflation target. The inflation target is pursued in the medium run, with due

concern for avoiding real instability, for instance, in the output gap; that is, inflation targeting is "flexible" rather than "strict." Second, due to the unavoidable lags in the effects of instruments on inflation, the decision framework is in practice "inflation-forecast targeting" (see below). Third, communication is very explicit and to the point; policy decisions are consistently motivated with reference to published inflation and output (-gap) forecasts. Indeed, inflation targeting has introduced unprecedented transparency and accountability in monetary policy. Three central banks (the Reserve Bank of New Zealand, the Bank of England, and Sweden's Sveriges Riksbank) stand out as particularly consistent and transparent in their implementation of inflation targeting.

I. Goals

The Maastricht Treaty assigns price stability as the primary objective for the Eurosystem but leaves to the Eurosystem the formulation of an operational definition. In October 1998, the Eurosystem defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2%" (European Central Bank, 1998a). It has several times emphasized the medium-term orientation of its policy and that a gradualist and measured response to threats to price stability will not introduce "unnecessary and possibly self-sustaining uncertainty into short-term interest rates or the real economy ..." (European Central Bank, 1999). This emphasis on the medium term, gradualism, and stability of the real economy is consistent with "flexible" rather than "strict" inflation targeting.

However, as commentators quickly pointed out, the Eurosystem's definition of price stability was ambiguous, since it did not specify a lower bound for inflation. In November 1998,

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¹ A more detailed discussion of the Eurosystem is given in Svensson (1999b). Inflation targeting is discussed in Ben S. Bernanke et al. (1999) and Svensson (1997, 1999a).

the ECB president, Willem Duisenberg (1998a), clarified that the word “increase” should be interpreted as excluding deflation. It would seem to follow that the lower bound was zero and that the definition refers to an inflation rate between 0 percent and 2 percent. However, two days later, Duisenberg (1998b) stated that “[w]e did not announce a floor for inflation, because we know that the price index may include a measurement bias, but we do not know its magnitude.”

If the lower bound is zero, it would seem logical to use the midpoint, 1 percent, as the point inflation target in the calculation of the M3 reference value. However, when the reference value was announced in December 1998 (European Central Bank, 1998b), it appeared that a point inflation target of 1.5 percent had been used instead.

To this date (January 2000), so far as I know, the Eurosystem has not yet been explicit about the lower bound. If this omission were due to uncertainty about possible measurement bias, it would seem that this would affect both the lower and upper bound to the same extent; otherwise, the width of the range becomes dependent on the measurement bias. It is difficult to see any benefit from such ambiguity. An unambiguous symmetric definition (for instance, “above 0 percent and below 2 percent”) seems preferable, especially since deflation may be as serious a threat these days as inflation.²

II. Decision Framework

Although inflation targeting is technically difficult in practice, the principles of inflation targeting are relatively straightforward. Given that monetary policy actions affect inflation with a lag, efficient inflation targeting requires inflation-forecast targeting (see, e.g., Svensson, 1997, 1999a; Svensson and Michael Woodford, 1999). That is, the central bank needs to make conditional inflation forecasts (conditional on its view of the transmission mechanism, the

current state of the economy, and a given planned path for its instrument rate). The bank then selects the instrument plan that results in an “optimal” inflation forecast, that is, an inflation forecast that approaches the inflation target at an appropriate pace without causing too much variability in the real economy or interest rates. The bank then starts implementing the instrument plan, by setting the interest rate accordingly. At regular intervals, if new significant information has been collected, the procedure is repeated, and a new interest-rate plan adopted and implemented. From this perspective, inflation-forecast targeting is just an algorithm to solve an intertemporal optimization problem. With minor differences, this is the decision framework used by all inflation-targeting central banks.³ Thus, if the Eurosystem wants to meet its definition of price stability in the medium term, it must decide on an instrument plan such that the corresponding inflation forecast in the medium term, conditional on all relevant information and its instrument plan, falls between the undisclosed lower bound and the upper bound of 2 percent.

In October 1998, the Eurosystem (European Central Bank, 1998a; see also European Central Bank, 1999) announced that the monetary-policy strategy would consist of “two key elements,” later called “the two pillars”: The first pillar is “a prominent role for money” with a reference value for M3 growth, set at 4.5 percent in December 1998 (European Central Bank, 1998b). Monetary targeting per se was rejected, however. Instead, money’s role as an indicator of future inflation was emphasized: “Deviations of current monetary growth from the reference value would, under normal circumstances, signal risks to price stability.” The reference value was reconsidered in December 1999 and maintained at 4.5 percent. The second pillar is a “broadly-based assessment of the outlook for price developments and the risks to price stability,” where the assessment is made

² The Eurosystem’s “below 2%” is reminiscent of the brief period when the previous Chancellor of Exchequer specified the Bank of England’s inflation target as the ambiguous “2.5 percent or less,” leaving open the interpretation of “or less.” The current Chancellor wisely removed the “or less.”

³ As discussed Svensson (1999a) and Svensson and Woodford (1999), inflation-forecast targeting can be interpreted as a “targeting rule” and is different from a commitment to a simple “instrument rule” (like a Taylor rule). The latter paper also discusses to what extent inflation-forecast targeting can achieve the socially optimal monetary policy under commitment.

“using a wide range of economic and financial variables as indicators for future price developments.”

From the above discussion, it is clear that the first pillar is redundant. Only the second pillar is needed, if interpreted as a conditional forecast, taking into account all relevant information, including that in monetary aggregates. There seems to be no rational reason for giving a certain set of indicators of future inflation the status of a separate “pillar” (rather than one of the bricks in one main pillar). This instead makes the framework inconsistent and ambiguous, as several observers have noted. In contrast, when the Swiss National Bank (1999) in December 1999 announced that it would abandon monetary targeting, it simply made clear that “[m]onetary policy decisions will be based mainly on an inflation forecast, which will take all relevant indicators into account.”

III. Communication

Inflation-targeting central banks have expended considerable effort to explain past outcomes and to motivate current policy decisions, typically with reference to published conditional inflation forecasts. For instance, Sveriges Riksbank organizes its quarterly *Inflation Report* (see e.g., Sveriges Riksbank, 1999) according to its view of the transmission mechanism and the determination of inflation; it also systematically updates its estimates of the main determinants of inflation and summarizes the resulting adjustments in its conditional inflation forecast relative to that reported in the previous *Inflation Report*. The degree of uncertainty in the forecast is also updated and assessed in each *Report*.

These practices of inflation-targeting central banks allow outside observers to scrutinize the central banks' analysis and forecasts and then judge whether the policy decisions taken are appropriate, given the goals and available information. Several central banks also publish minutes from the monetary-policy meetings, which allows outsiders further to assess whether the discussion and analysis are competent, whether the various arguments presented are appropriate, and whether final decisions are consistent with the goals. Altogether, this commitment to communicate simplifies outside monitoring and

evaluation of monetary policy, strengthens the accountability of the central banks, and provides stronger incentives for the banks to fulfill their announced goals. Compared to previous monetary-policy regimes, inflation targeting has introduced an unprecedentedly high degree of transparency into monetary policy.

How does the Eurosystem compare? So far the Eurosystem has not published its most crucial information, the internal forecasts. Indeed, initially keeping the forecasts secret was considered a virtue (Duisenberg, 1998a): “... publishing an inflation forecast would obscure rather than clarify what the Governing Council is actually doing. ... [B]ecause publishing a single inflation forecast would be likely to suggest that monetary policy reacts mechanistically to this forecast, publication might mislead the public and therefore run counter to the principle of clarity.” However, since September 1999, several public statements have indicated that forecasts will be published, and in December 1999, Duisenberg (1999) stated: “We, of course, also compare those [external] forecasts with our internal preliminary forecasts, which will ultimately be published in the course of next year” The extended quarterly versions of the ECB's *Monthly Bulletin* of June, September, and December 1999 have started to report external forecasts. Duisenberg (1999) actually seems to reveal ECB's internal forecast: “... the European Commission also forecasts average inflation in 2000 and 2001 to be 1.5%, and we see no reason to deviate from that forecast” [emphasis added]. Duisenberg did not reveal whether this number should be interpreted as an unconditional forecast (conditional on optimal policy by the Eurosystem) or a conditional forecast (for instance, conditional on an unchanged interest rate). In the former case, it seems that 1.5 percent for 2001 should probably be interpreted as the Eurosystem's point inflation target (consistent with the inflation target used in the calculation of the M3 reference value).

The Eurosystem does not publish minutes and voting records of the General Council meetings. Instead, it has argued that the introductory statement at the press conference held immediately after the meetings is similar to “summary minutes.” If that is the case, a comparison of the statements with the minutes of Bank of England and Sveriges Riksbank gives the unfortunate

impression that the Eurosystem is considerably less advanced, systematic, and forward-looking than those banks. The two-week delay in publishing the minutes from Bank of England is probably close to the minimal time necessary to summarize and edit sophisticated and detailed discussions and arguments. In any case, a press conference is certainly not a commitment to give an adequate report of the discussions at a meeting and, rather, an invitation to a somewhat selective presentation.

The Eurosystem's reluctance to be more open and transparent, in particular, in publishing internal forecasts and minutes, has probably been quite costly from a public-relations perspective. The Eurosystem's repeated pronouncements about its high degree of transparency (e.g., Ignazio Angeloni and Otmar Issing, 1999) have not carried far, since critics have the easy task of pointing to other central banks that are clearly more transparent.

IV. Actual Instrument Decisions

The Eurosystem's main instrument is its "main refinancing rate," a short repurchase rate. On 22 December 1998, the Eurosystem announced that it would set an initial rate of 3 percent. On 8 April 1999, the rate was lowered to 2.5 percent. On 4 November, the rate was increased to 3 percent. Were these decisions appropriate, given the goals of the Eurosystem and the information available at the times of decision?

Did the Eurosystem take its controversial first pillar into account? Between October 1998 and October 1999, the three-month moving average of 12-month M3 growth rates fluctuated between 4.7 percent and 6.0 percent. At the time of the decision in April, the three-month moving average of the 12-month M3 growth through February was 5.1 percent, well above the reference value of 4.5 percent (the money-growth rate is published with about four weeks' lag). Presumably, this should have motivated an increase rather than a decrease of the interest rate. During March–September, the moving average rose steadily to 5.9 percent, motivating an increase, but not necessarily as late as November. Obviously, the first pillar has been disregarded at the Eurosystem's discretion—hardly surprising, given its redundancy.

Instrument decisions should ideally be evaluated *ex ante*, given the information available to the Eurosystem at the time of the decisions. The crucial information would include the Eurosystem's internal conditional inflation forecasts during the period, for instance, the conditional inflation forecasts for 3-percent and 2.5-percent interest rates in April and November, respectively. Since the Eurosystem has declined to make this information available and to allow outside scrutiny of its forecasts, it is not possible to decide with any precision whether the decisions were appropriate. Using external forecasts is problematic, since the assumptions of external forecasters about Eurosystem monetary policy need to be sorted out. Nevertheless, it is reassuring that external forecasts, as reported in the ECB's December 1999 *Monthly Bulletin* (and apparently also internal forecasts; see above) point to average inflation of 1.5 percent in 2000 and 2001.

Because of the transmission lags in monetary policy, it is too early for any *ex post* evaluation of Eurosystem decisions. Another year or two will be needed for that. Since actual outcomes are contaminated by shocks occurring after instrument decisions, or unknown at the time of decisions, *ex post* evaluation is far from straightforward. Missing the target range is not necessarily evidence of a mistake, and meeting it is not necessarily evidence of good decisions.

V. Conclusions

The first year of the Eurosystem has seen a successful launch of the Euro and an apparently successful introduction of the common monetary policy. The Eurosystem monetary strategy is quite similar to flexible inflation targeting, for instance, in having a quantitative definition of price stability, in the emphasis on the medium term, and in the concern to avoid real instability. Eventual publication of internal forecasts would increase this similarity. There seem to be no fatal mistakes in either design or instrument-setting. Still, there is considerable room for improvement with regard to internal consistency and transparency of the regime.

The remaining asymmetry and ambiguity in the definition of price stability, although minor, does not serve any useful purpose. The insistence on the separate first pillar is an important

source of ambiguity and inconsistency. The first pillar is redundant (as also indicated by the first year's experience). A rational role for monetary aggregates is to contribute to conditional forecasts, among other indicators and according to their predictive power, as for the inflation-targeting central banks (and now apparently also the Swiss National Bank). There is considerable room for increased transparency about General Council meetings. The introductory statements at the press conference after the meetings are hardly enough, certainly not if the meetings become more sophisticated and are the genuine locus for decisions. It is difficult to see how the Eurosystem could lose from further increases in consistency and transparency.

It is worth emphasizing that, since the ECB was created in 1998, it has made sincere efforts to maintain an open dialogue with academic researchers and external experts, including critics, as witnessed by an active visitors' program and its participation in and organization of a number of academic conferences. Visitors to the ECB have also experienced open-minded, sophisticated, and informative discussions with a very competent and insightful staff. Overall, I believe there are good reasons to be optimistic about the future of Eurosystem monetary policy.

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