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The ECB's "New" Strategy

On May 8 the European Central Bank (ECB) announced that it had adopted a new strategy. At the same time, it reinforced the main elements of its old strategy, adopted in 1998. Accordingly, the ECB continues to consider three elements as the basis for its policy decisions. There is a quantitative target for the rate of inflation that is considered to be compatible with price stability, and projections of price stability will continue to be based on developments in the growth of the money supply (M3) and on a more broadly based consideration of other variables deemed to be important for assessing the risks for price stability. The main revisions are that the rate of inflation regarded as desirable is still to be 2 per cent, but while 2 per cent was previously considered to be the maximum rate permissible, while no lower bound had been declared, now the rate of inflation should be close to 2 per cent. This apparently small change is considered enough to avoid the danger of deflation in the euro-zone. The other change is small as well. While the ECB used to begin its explanations of policy decision by describing the development of the money supply and then continued with a broader economic analysis, this order will be changed. From now on, the explanations by the President will begin by discussing the economic analysis before turning to the monetary analysis. This new order should help to make clear to the public that the economic analysis captures the short to medium term developments, to be supported by the medium to long-run perspective based on changes in the money supply. Moreover, to underline the longer term importance of the money supply, the reference value for the money supply shall no longer be revised every year.

This revision of its strategy by the ECB is its response to the growing criticism that the dangers of deflation, at least in the larger countries of the euro-zone, are now greater than the dangers of inflation. Particularly Germany, with recent negative growth rates, is considered to be much closer to deflation than anything else, and talk about the Japanese situation spilling over to Germany is rampant. The strong appreciation of the euro against the US dollar and the British pound in recent months has only supported this process. Moreover, the ECB had long been criticised for its focus on the money supply, this obviously being a relic of the Bundesbank's monetary strategy. The Bundesbank had been able to achieve low rates of inflation while violating its money supply targets almost as often as it met them, however, and the ECB also had apparently not paid too much attention to its money supply target. Most observers argued that the money supply pillar in the two-pillared ECB strategy was based more on political considerations than on sound economic ones. Discarding the role of the money supply in the ECB's strategy and changing to a declared inflation targeting strategy was long overdue according to this view.

The ECB could not bring itself to make this decision, however. The 18 members of the council, the 6 members of the board and the 12 national central bank presidents, were not able to consent to a clear solution. The confusion created by their weak decision was further increased by the ECB's chief economist and member of the board, Otmar Issing, who declared immediately after the release of the statement that there was nothing new in the ECB's strategy. It cannot seriously be claimed that this was a convincing answer to the ECB's critics. What the ECB should do, instead, is to make a clear change to one

single goal for monetary policy, and that goal can only be to keep inflation under control. A single-pillared strategy based on an inflation target would certainly help to bring the ECB's rhetoric closer to what it is obviously doing anyway. The half-hearted change that has been announced misses this opportunity.

Nor is the small change concerning its inflation target likely to soothe critics. Most observers agree that the ECB should be adopting a symmetric inflation target, allowing deviations around this target instead of formulating an absolute upper ceiling. This would clearly signal that the ECB is as strongly committed to avoiding deflation as it is to avoiding inflation. Again, the vague revision that has been made does not make this as clear as a symmetric target would. Apart from this, many would probably argue that an absolute upper limit of 2 per cent for inflation is too low. Most inflation-targeting central banks aim for 2.5 or 3 per cent. And a monetary union comprised of countries which are so diverse in their economic development and where growth rates differ by so much as they do currently, would probably be served better by a more generous inflation target. A clear change in the strategy of the ECB would also have been better suited to deal with the fact that there may be a number of new members of the monetary union as early as 2006. Given the rapid changes and development in these economies, the money supply is likely to be rather unstable, discrediting the importance of the money supply for predicting the rate of inflation. Rapid financial sector developments in the new member countries will make the money demand function highly unstable without necessarily signalling the build-up of inflationary risks. Recognising this, the ECB could have made clear that it is looking ahead to these new members by changing the way its target is set. Instead, it will either have to change its strategy again in a couple of years or the irrelevance of money supply data will become even more obvious than it has in recent years. Moreover, Sweden will have a second referendum on September 14 of this year on whether to join the monetary union, and the British government will review the status of its five conditions for joining the common currency in June. Since both countries currently operate a clear inflation-targeting policy regime, a corresponding decision by the ECB might have signalled a higher compatibility of the ECB's policy with those monetary policy regimes.

While the decision by any of the candidate countries, or by Sweden or the UK, to join the euro will not be based on what monetary strategy is officially pursued, a clearer strategy could nevertheless have sent a welcome signal. What the policy revision by the ECB has shown instead is that it is still influenced by the monetary policy dogma of the Bundesbank. The Bundesbank was stubborn in its defence of the money supply target when everybody well knew that it was actually following a much more pragmatic course. Whether this inconsistency really helped to increase its credibility is doubtful. And transferring an obviously outdated and inconsistent strategy to a new institution was probably not a good idea either. Thus, the credibility of the ECB, one might argue, has been acquired despite its money supply pillar and not because of it. In that sense, the ECB will be able to continue to send mixed signals and not undermine its credibility by too much. Optimists might even think that the revision of the strategy has been a first, albeit small, step towards aligning rhetoric and behaviour, and that maybe the ECB council will be able one day to push out the money supply relic completely. But the fact that it has not already been able to do so is unfortunate. Hopefully, the ECB will be able to revise its 2 per cent inflation target more quickly once it becomes clear that it is no longer adequate, as some voices have already been maintaining for some time. If dogmatism is as important there as it is in the defence of the two pillars, the larger euro-zone will pay a steep price.

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