Editorial

European Central Bank strengthens monetary policy accommodation – ECB monetary policy strategy needs to be reviewed

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The first months of 2019 have confirmed that global economic activity has undergone a change for the worse. Political uncertainty and trade tensions have eroded the outlook for the economy. However, at present, this change does not seem to imply entering into a recession but rather a transition to a phase of more sluggish growth. While at the end of last year many still hoped that the stagnation of growth would remain transient, it is now turning out to be more persistent and has led to substantial downward revisions to growth forecasts for the current year nearly everywhere.



Naturally, the turn in the global economy will also affect the outlook for the European and Finnish economies. The European Central Bank has already reacted to this at its meeting on 7 March 2019 by taking decisions that reinforce the monetary policy stimulus. For Finland, the turn for the worse in the global economy highlights the importance of maintaining fiscal sustainability and the competitiveness of Finnish work and output – even in an election period.

The situation is challenging for the ECB, as it must simultaneously operate in two different time frames. On one hand, it has to take strong short-term measures in order to achieve its price stability objective in a situation where underlying inflation excluding energy and food prices hovers around 1%. It has turned out that, with such low levels of underlying inflation, the ECB's price stability objective of “below, but close to, 2%” cannot be achieved in a sustainable manner. On the other hand, the ECB must prepare itself for longer-term challenges which would necessitate a review of its monetary policy strategy – that is, a re-examination of the principles, key assumptions and instruments underlying its monetary policy. This idea has been discussed for some time already, and in November the US Federal Reserve announced it would launch a similar exercise. Undoubtedly the ECB will do the same when the time is ripe.

Global economic outlook dampened in 2018

The outlook for the global economy deteriorated in the second half of 2018 as protectionism (in trade policies) and uncertainty about growth in major economic areas weakened confidence and dampened growth in global trade. Export growth in advanced economies receded sharply. Slower growth in China is an additional concern.

In the next few years, GDP growth in the euro area is anticipated to fall clearly behind previous expectations. The ECB staff projections foresee GDP growth rates of only 1.1% for 2019 and 1.6% and 1.5%, respectively, for 2020 and 2021. The projection for 2019 has been revised strongly downwards, by 0.6 of a percentage point.

The outlook for prices has also become more subdued since December last year. Inflation expectations estimated on the basis of financial market prices (inflation-linked swaps) have decreased markedly. Long-term inflation expectations now stand at levels around 1.5%. The deviation of inflation expectations from the ECB's target is worrisome in terms of the effectiveness of, and strategy for, monetary policy.

Compared with earlier staff projections, ECB staff now forecast a clearly slower increase in the price level, with headline inflation foreseen to be 1.2% in 2019 and 1.5% and 1.6% respectively in 2020 and 2021. Over the short term, this downward revision is mainly explained by a lower oil price. Following a broadly similar path, underlying inflation is projected to be 1.2% in 2019 and 1.4% and 1.6%, respectively, in 2020 and 2021, reflecting only slowly increasing price pressures and lower (output) capacity utilisation than in previous forecasts.

The dampening of the economic outlook has had an impact on monetary policy worldwide. The Governing Council of the ECB decided at its meeting in March to keep the key ECB interest rates unchanged for a longer period than it had previously anticipated: it now expects them to remain at

their present levels at least through the end of 2019. In order to support bank lending, the Governing Council also decided to launch a new series of targeted longer-term refinancing operations (TLTRO III). The operations will be conducted on a quarterly basis, starting in September 2019 and ending in March 2021.

The ECB's monetary policy decisions were taken to support a sustained convergence of inflation to levels that are below, but close to, 2% over the medium term in a situation in which underlying inflation remains muted and too weak economic growth slows down the return of the inflation rate towards levels in line with the objective. Already at the turn of the year, the dampening economic outlook also caused the US Federal Reserve to stress patience in its future monetary policy and to delay the increase in its policy rates.

Why do we aim at inflation rates of around 2%?

Of course, one can ask why striving to achieve inflation rates of just below 2% is so important. Could one not claim that price stability has been achieved already when clearly lower inflation rates prevail? When the ECB's current objective was defined in 2003, it was justified by three arguments.[1]

First, the goal was to reduce the probability of a situation in which the zero lower bound would restrict the room for monetary policy manoeuvre. If average inflation were to slow to rates markedly below 2%, this would also push down nominal interest rates and thus limit the room for interest rate policy. Later on, this factor has turned out to be more important than anyone apparently could have expected at that time.

The second aim was to reduce the probability that some countries would have to operate in an environment of negative inflation rates if restoring their competitiveness required inflation rates below the euro area average. This is because negative inflation is associated with several drawbacks owing to, for instance, the downward rigidity of prices and wages. This justification has also turned out to be very valid.

The third justification referred to back in 2003 was that a certain bias cannot be avoided when measuring inflation and that actual inflation is, for several reasons, slightly slower than what consumer price indices suggest.

Naturally, all these factors have been understood outside the euro area, too, and consequently 2% has become a common benchmark worldwide for defining monetary policy objectives.

ECB monetary policy needs to be reviewed

During the past 10 years or so, central banks have seen their economic environment change as a result of the impact of the financial and debt crises, an ageing population and generally lower interest rates, to mention just a few causes. The changes in the environment, the past years' experiences from non-standard monetary policy measures, as well as accumulated research evidence challenge central banks to review their monetary policy strategy.[2]

The most recent update of the ECB's monetary policy strategy took place in 2003 – before the financial crisis and other, subsequent events and changes. Monetary policy strategies are currently being discussed across the world more vividly than for a long time. The Eurosystem, too, should consider performing a new systematic review of its monetary policy strategy.

Several factors call for a strategy review. One of them is that risk-free nominal short-term interest rates have decreased to very low levels. If this prevailing environment of very low rates turns out to be a long-lasting phenomenon, as several studies suggest, the room for manoeuvre for traditional interest rate policies, especially in an accommodative direction, remains narrower than was customary before the financial crisis. In recent years, it has been possible to complement the interest rate policy with non-standard measures, such as asset purchases by central banks, but the desired strengthening of inflation in the euro area has still not materialised.

Another factor with monetary policy relevance is that the interdependence of economic activity and inflationary pressures seems to have weakened in recent years, causing a flattening of the Phillips curve. Should this phenomenon prove to be lasting, it would imply a weakening of the impact monetary policy exerts on inflation via aggregate demand.

Thirdly, inflation expectations have decreased in the euro area in recent years, thus deviating from the ECB's definition of price stability (an inflation rate below, but close to, 2% over the medium term). One explanation for this is that, for the reasons mentioned above, trust in central banks' ability to influence the inflation rate may have eroded.

Together, these three factors call for a reassessment of the ECB's monetary policy strategy. Naturally, this would not mean questioning the primary objective of price stability, but it would indeed entail a comprehensive review of the guiding principles, key assumptions and tools used for the implementation of monetary policy.

Among the most important tasks of the monetary policy strategy is to steer the expectations regarding monetary policy and inflation in such a way that supports the achievement of monetary policy objectives – above all price stability – in the current, much more demanding circumstances.

In fulfilling this task, a good strategy also underpins the scope for monetary policy to stabilise real economic developments and thereby maintain sustainable growth and high employment. If the strategy reassessment were to lead to enhancements that would increase the effectiveness and credibility of monetary policy, it would have fulfilled its purpose.

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Notes

1. See 'The ECB's Monetary Policy Strategy After the Evaluation and Clarification of May 2003', speech by Jean-Claude Trichet, Frankfurt am Main, 20.11.2003. See 'The Monetary Policy of the ECB', Frankfurt am Main, European Central Bank 2004, pp. 51–54. ↑
2. See 'The Federal Reserve's review of its monetary policy strategy, tools, and communication practices', a speech by Richard H. Clarida, Vice Chairman of the US Federal Reserve, on the grounds and objectives of the strategy review at the 2019 US Monetary Policy Forum, New York City, 22 February 2019. ↑

Keywords

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