

Attachments at end

The monetary policy framework of the ECB

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1. Introduction

When the ECB started its operations in January 1999, it was confronted with the difficult task of conducting monetary policy in a completely new environment. This implied an especially high degree of uncertainty about the transmission process (ECB 1999, p. 45):

- As the regime shift to a common monetary policy was likely to change the way *expectations* are formed, there was a risk that empirical relationships between economic variables that have been estimated using data from the past may become unstable. Such changes were expected above all for the financial sector where the impact of Monetary Union was most pronounced. As a consequence, the information content of monetary aggregates was lower than under normal conditions.
- In addition, the creation of European Monetary Union had led to an entirely new economic area for which *comprehensive and harmonised data* had not been collected in the past. A number of fully, or almost fully, harmonised series became available just at the beginning of Monetary Union (monetary data, the balance of payments data and the Harmonised Index of Consumer Prices). As these euro area-wide statistics are based, in part, on new concepts, the properties of the series were well known.

In this short presentation I cannot discuss the concrete definition of the ECB's final target which is an increase of the harmonised index of consumer prices in the euro area of "below 2 percent". Thus, I will focus on the monetary policy framework that the ECB has developed in order to achieve its target. In its own view the ECB has developed a completely new strategy which it calls "stability-oriented monetary policy strategy":

"The Eurosystem's stability-oriented monetary policy (...) is a new and distinct strategy, which reflects the unique circumstances and institutional environment that will face the Eurosystem." (ECB 1999, p. 50).

Basically the ECB's approach rests on two or even three "pillars":

- The first pillar is provided by a "*reference value*" for the money stock M3, with which the ECB intends to assign a "prominent role" to money and which can be regarded as a weak form of monetary targeting.
- As the second pillar the ECB has established a "*broadly based assessment of the outlook of price developments*". While one could think that this pillar has some affinity to the concept of inflation targeting, we will see that the ECB does not subscribe this view.
- An implicit third pillar is a strategy of flexible exchange rates for the relations of the euro vis-à-vis the yen and the dollar.

2. The first pillar: A reference value for the money stock M3

In contrast to the Bundesbank, the ECB has not decided to pursue an outright monetary targeting. This can be explained by the fact that of the two requirements for an intermediate target only one is met in the euro area. As far as the control of inflation by the money stock is concerned the ECB states:

"(...), substantial or prolonged deviations of monetary growth from the reference value would, under normal circumstances, signal risks to price stability of the medium term." (ECB 1999, p. 48).

The problematic issue is the control of the money stock M3 with short-term interest rates. [4]
Here, the ECB concedes:

"(...), the euro area monetary aggregate for which the reference value is announced does not need to be controllable in the short run, using a short-term interest rate influenced closely by the Eurosystem." ECB (1999, p. 48)

Thus, it is consequent that the ECB decided to adopt only a weak form of monetary targeting in the form of a "reference value" for the money stock M3. The rationale of a "reference value" is explained by the ECB (1999, p. 48) as follows:

"However, the concept of a reference value does not entail a commitment on the part of the Eurosystem to correct deviations of monetary growth from the reference value over the short term. Interest rates will not be changed "mechanistically" in response to such deviations in an attempt to return monetary growth to the reference value."

Thus, one could say that the ECB uses the monetary growth not as intermediate target but as a “prominent” indicator of medium-term risks for price stability. But a main problem of this approach is the low quality of monetary growth rates if they are used as the single indicator of price stability.¹[5] Figure 1 shows that especially since 1995 the growth rate of M3 is not very closely related to the inflation rate in the euro area.

As far as the derivation of the reference value is concerned, we have already seen that the ECB has completely adopted the Bundesbank’s potential formula and even the concrete values of its determinants. In contrast to the Bundesbank, the ECB formulates the reference value not in the form of a target corridor. Instead it compares a *three-month moving average of annual growth of M3* with its reference value.

While there are some minor differences between the ECB’s and the Bundesbank’s approach, [6] they both share the problem that they have not been designed as a medium-term benchmark. In the case of the Bundesbank this was due to annual targets and the practice of the base shifts, ie the use of actual values instead of normative values as the starting base for the subsequent year. In the case of the ECB the medium-term orientation gets lost because of the comparison with annual growth rates. This has the effect that an excessive monetary growth in one year will simply grow out of the data as soon as twelve months have passed. Therefore, the only consequent application of a reference value would be a comparison with long-term monetary growth rates. In other words, the present practice of the ECB is not compatible with the aim of identifying medium-term risks to price stability.

In the actual monetary policy of the ECB, the influence of the monetary pillar cannot be easily identified. As already mentioned, the main problem of this approach is the confusion about the interest rate elasticity of M3. The ECB and many of its watchers erroneously believe in a negative elasticity of M3 in regard to short-term interest rates. But this is simply wrong. Therefore the first interest rate decision of the ECB, a reduction of interest rates in April 1999, when the monetary growth rate was about one percentage point above the reference value was

¹ Svensson (1999: 34) states: “It is easily shown (...) that such a money-growth indicator will be a relatively useless indicator of risks to price stability and, indeed, mostly a noisy indicator of the deviation of current inflation from the inflation target.”

- incorrect as far as the ECB's understanding of the interest elasticity is concerned, and
- correct as far as the true elasticity is concerned.

In the following decisions to increase interest rates the ECB has always emphasised a negative impact of short-term interest rates on the growth rate of money. For instance, at a press conference on 6 July 2000 Duisenberg (2000) made the following statement:

“The increase in ECB interest rates on 8 June - in conjunction with the interest rate increases made since November 1999 - exerts a moderating influence on both money and credit growth” .

9.1.1 The second pillar: a broadly based assessment

At first sight, this pillar seems to be identical with an inflation forecast by the ECB with a confidence band. However, the ECB tries to avoid that term “forecast” although it is not clear why an “assessment of the outlook for price developments” should be qualitatively different from an “inflation forecast”.

This assessment is based on “a wide range of economic indicators” which “will include many variables that have leading indicator properties for future price developments” (ECB 1999, p. 49) . They “include inter alia:

- wages,
- the exchange rate,
- bond prices and the yield curve,
- various measures of real activity,
- fiscal policy indicators,
- price and cost indices and
- business and consumer surveys”. (ECB 1999, p. 49)

It is somewhat astonishing that this pillar does not include monetary data (money stocks and/or short-term interest rate). Of course, the ECB could argue that this information is already processed by the first pillar, but it is nevertheless difficult to understand how an assessment of future price developments can be made without such indicators and how the relationship of the two indicators is to be interpreted. .

The presentation of this “assessment” by the ECB looks very much like a “look at everything strategy” (Bernanke et al. 1999, p. 22). This would not be objectionable, but in this case this pillar could not be regarded as a major contribution to the transparency of the ECB. It would simply state what is obvious: the ECB wants to take into account all information that is relevant for future price developments.

4. The ECB lacks a clear policy framework

It is widely agreed that a strategy or a policy framework serves two main purposes: By reducing the complexity of the reality to set of relatively simple rules it helps

- to facilitate internal decision processes of a central bank, and
- to structure the dialogue with the public which contributes to the transparency, accountability and hence credibility of monetary policy.

The discussion of both pillars of the ECB’s stability-oriented monetary policy strategy shows that this strategy is at the same time too narrow and too general to serve as a framework that could fulfil these two functions. While the first pillar pays too much attention to monetary growth, the second pillar simply states that the ECB will look at all relevant factors. In addition, it is not clear what has to be done if the two pillars give contradicting signals.

The ambiguity of the ECB’s strategy raises the question of how the ECB takes its interest rate decisions. At the moment the experience with the ECB is still relatively limited so that no definitive answer can be given. But there are some indications that the Taylor rule - in the same way as in the case of the Bundesbank - provides a relatively good explanation of the level and of the changes in the ECB’s interest rates. Figure 1 shows that the repo rate in the euro area has always been relatively close to a Taylor rate on the basis of the core inflation rate for the euro area, an inflation target of 2 % and an assumed average short-term rate of 2.8 %. As Gerlach and Schnabel (1999: 4) show, with such a policy the ECB does “not deviate much from past (weighted) interest rate behaviour in the countries forming the EMU area.”

It seems relatively obvious that the ECB needs a more coherent policy framework. Above all, the monetary pillar should be integrated in the “broadly based assessment”. As this would

lead to a single-pillar approach, the “broadly based assessment” would have to become more informative than now. Thus many critics encourage the ECB to adopt the inflation targeting framework of the Bank of England (Buiter 1999, Svensson 2000).

5. What the ECB can learn from inflation targeting

After its introduction by the Reserve Bank of New Zealand in April 1988, the concept of inflation targeting is now practised by an increasing number of central banks all over the world². Many academics regard this concept as an “apparent success” (Svensson 2000) and recommend it also for the European Central Bank and the Federal Reserve System (Bernanke et al. 1999). This view is difficult to reconcile with the monetary policy in the United States under the aegis of Alan Greenspan which is widely regarded as successful although it lacks a clearly defined conceptual framework. The need for a switch to inflation targeting is also not obvious in the case of the ECB which has been able to keep inflation expectations at historically very low levels in spite of much public scepticism about the new currency.

In the following we will discuss what the introduction of inflation targeting would imply for the ECB’s strategy. Above all we will analyse whether it is true that this approach would increase the ECB’s accountability vis-à-vis the European public (Buiter 1999)

5.1 Elements of inflation targeting

In a comprehensive study on “inflation targeting” Bernanke et al. (1999) give the following definition of inflation targeting:

“Inflation targeting is a framework for monetary policy characterised by the public announcement of official quantitative targets (or target ranges) for the inflation rate over one or more time horizons, and by explicit acknowledgement that low, stable inflation is monetary policy’s primary long-run goal. Among other important features of inflation targeting are vigorous efforts to communicate with the public about plans and objectives of monetary authorities, and in many cases, mechanisms that strengthen the central bank’s accountability for attaining those objectives.” (Bernanke et al. 1999, p. 4)³

² Canada (February 1991), United Kingdom (October 1992), Australia (1993), Sweden (January 1993), Finland (February 1993), Spain (November 1994); Brazil (July 1999).

³ An additional element of “inflation targeting” as it is presented in the study by Bernanke et al. is a preference for an inflation target that is set by “elected officials”: “Because ultimately policy objectives in a democracy must reflect the popular will, they should be set by elected officials.” (Bernanke et al. 1999, p. 312). We do not discuss this aspect because it would be completely incompatible with the legal independence of the ECB stipulated by the EC Treaty.

This definition is much less demanding than a definition that was made by Lars Svensson who can be regarded as the theoretical head of inflation targeting :

„Inflation targeting is characterised 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’ (...). Third, communication is very explicit and to the point; policy decisions are consistently motivated with reference to published inflation and output(-gap) forecasts.“ (Svensson 2000, p.1)

Although the ECB does not regard itself as an inflation targeter, it is obvious that it can easily meet most of the criteria listed in these two definitions:

- “*Low, stable inflation*” is clearly the ECB’s “primary long-run goal”. It is defined in an unambiguous way by Article 105 of the EC-Treaty.
- As already mentioned in its “stability-oriented monetary policy” the ECB (1999, p. 46) has announced a *quantitative target range* for the inflation rate: “Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%”.⁴ The time horizon has also been specified: “Price stability is to be maintained over the medium-term.”
- With its Monthly Bulletin, the monthly press conferences and the quarterly hearings before the Committee on Monetary and Economic Affairs of the European Parliament the ECB is certainly undertaking “vigorous *efforts to communicate* with the public about plans and objectives”.

Thus, as far as the criteria of Bernanke et al. are concerned, the ECB’s approach - and by the way also the Bundesbank’s policy in the period from 1975 to 1998 – could easily qualify as inflation targeting. Thus, in order to identify the specific features of inflation targeting, the more demanding definition by Svensson is required. It makes clear that an adoption of inflation targeting would indeed require major changes in the ECB’s strategy.

- The ECB’s *decision framework* would have to become “inflation forecast targeting”.

⁴ The ECB (1999, p. 46) has also clarified that “the use of the word ‘*increase*’ in the definition clearly signals that deflation, i.e. prolonged declines in the level of the HICP index, would not be deemed consistent with price stability.”

- The internal inflation and output(-gap) forecasts of the ECB would have to be *published*.

By adopting these strategic elements, the ECB's policy would become very similar to the policy of the Bank of England, the Reserve Bank of New Zealand or Sveriges Riksbank.

5.2 An accountability deficit of the ECB

Given the complexity of the macroeconomic process, the need of a clear decision framework is obvious. By reducing the complexity to a set of relative simple rules, it provides a navigation system for monetary policy. This is needed for the *internal decision processes* within a central bank as well as for the *communication with the public*. Thus, the proponents of inflation targeting believe that this strategy would enhance the accountability of the ECB (Buiter 1999, Svensson 2000).

An intensive discussion between Willem Buiter (1999) and Otmar Issing (1999) shows that “*accountability*” is also not a clearly defined concept of economics. As a starting point one can agree with Issing (1999) that “given its European mandate and independent status, the Eurosystem as whole can only be held accountable by the European public and its elected representatives”. In addition it seems useful to distinguish between two forms of accountability:

- *Ex-post accountability* seems to be the ECB's main interpretation of accountability.⁵ It implies that the central bank has to justify ex-post if it has been unable to meet its target.
- *Ex-ante accountability* implies that the public is provided with an early warning system that allows to monitor a central bank's decisions on a permanent and to detect inflationary risks at an early stage. Thus, the central bank becomes accountable already for deviations of inflation forecasts from the target value.

It is obvious that the whole discussion on monetary policy strategies is only relevant in the context of ex-ante accountability. We have already argued that so far the experience with the “two pillar approach” of the ECB indicates that this strategy is indeed not been sufficiently transparent:

⁵ See Duisenberg (1999): Thus, publication of the forecasts cannot contribute to accountability. Rather, its performance in maintaining price stability in the medium term should be used by the public to judge the success of the Eurosystem”

Therefore, it is certainly justified if many academics urge the ECB to adopt a more transparent and more accountable framework. The question is whether inflation targeting as is currently practised, could provide the right alternative.

5.3 The framework of the Bank of England (BoE)

As the Bank of England can be regarded as one of the most sophisticated users of inflation targeting, we will start with a short description of its policy framework. It can be characterised by two basic rules:

- Monetary policy should be focused on keeping an inflation forecast close to the announced inflation target of 2.5%. Thus, Svensson (1998) calls this approach “inflation-forecast targeting”. The inflation forecast can be regarded as an *intermediate target* of monetary policy.
- When the forecast exceeds (falls short of) the target, short-term interest (the *operating target*) have to be increased (decreased).

In the inflation targeting framework the inflation forecast plays a similar role as the monetary target in the strategy of monetary targeting. Thus, for the transparency of inflation targeting the derivation of the inflation target is extremely important. The BoE provides its “inflation projection” in a quarterly “Inflation Report” together with a projection for real GDP. The forecast is presented as a *conditional forecast*, ie it is based on the assumption of a constant short-term interest rate⁶ and is made for a time horizon of two years in advance. The inflation projected is presented in the form of the so-called “fan chart” which can be regarded like a contour map.

Andrew Haldane (1997, p. 21), a senior economist at the BoE, explains how the Bank’s inflation projection is produced:

“The general point here is that the Bank’s published inflation projection is not a mechanical extrapolation from a single macro model. Rather, it draws upon much wider and richer set of information variables – quantitative and qualitative, real and monetary. Indeed, increasingly, the Bank’s published projection is also drawing on a wider set of models, as well as information variables. (...) The eclectic approach to the use of models mirrors the approach when using indicators (...). Using a ‘portfolio’ of models offers insurance against model

⁶ A different approach is followed by the Reserve Bank of New Zealand which makes its forecast conditional upon an interest rate *path*.

uncertainties. Diversification applies as much to policy-makers when choosing among uncertain indicators and macro models as it does to investors when choosing among uncertain securities and asset-pricing models.”

5.4 The information content of the BoE's inflation forecast

It seems obvious that this procedure which the Chief Economist of the BoE, John Vickers (1998) regards as “literally indescribable in detail” is anything but transparent. Thus, as far as the internal decisions are concerned, inflation targeting can offer little to reduce the complexity of the decision process. Bernanke et al formulate this as follows:

“(…) , at a technical level, inflation targeting does not provide simple, mechanical operating instructions to the central bank. Rather inflation targeting requires the central bank to use structural and judgmental models of the economy, in conjunction of whatever information it deems relevant, to pursue its price-stability objective. In other words, inflation targeting is very much a ‘look at everything’ strategy, albeit one with a focused goal.” (Bernanke et al 1999, p. 22).

Therefore, the guidance that inflation targeting provides to the decision-makers in the central bank's governing board can be summarised in three simple do's and don'ts :

- “Adopt a forward looking approach in monetary policy ”. But this has been widely known for a long time.
- “Do not rely on a single indicator like the money stock”. This has always been the practice of all central banks; even the Bundesbank was never paying too much attention to its monetary targets (Clarida and Gertler 1996, Schächter 1999).
- “Look at everything”. This is exactly the opposite what one would expect from a decision framework.

Given the prominent role of the inflation forecast in the whole exercise, it cannot be expected that such an “eclectic approach” will contribute to the *accountability* of monetary policy. The public and its elected representatives which are hardly able to make their own technical forecasts have no possibility to check by themselves whether the forecast is correct or not. As a central bank is basically a bureaucracy like any other, there is always the risk that it will produce a biased forecast in order to avoid public criticism. In addition as the forecast is conditional on the actual interest rate level, it cannot be compared with outside forecasts that are made on a projected interest rate path. In addition its information content is very limited.

What the public wants to know is whether there is a realistic interest rate path that allows to meet the inflation target within the foreseeable future. But what they can learn from the conditional forecast is what will happen under a *hypothetical* interest rate level. Thus, the only reliable information that can be derived from the publication of the forecast is the *direction* of interest rate changes, as a deviation of the conditional forecast from the target is a clear indication that the present level cannot be maintained. However, as the experience with the interest rate policy of the Fed, the Bundesbank and now the ECB shows the trend of interest rates is most of the time relatively clear.

5.5 What experts can learn from an inflation forecast

A central bank's inflation forecast could, therefore, mainly be of interest for the group of *experts* in private and official institutions that produce their own forecasts. In contrast to the public they are able to check the central bank's forecast which allows them to use it for an assessment of the *competence* of the central bank's staff. Thus, they could find out whether interest rate decisions are "due to luck or to technical expertise" (Buiters 1999). But this would be also possible without a published forecast. It is very unlikely that an incompetent central bank would permanently set interest rates in way that leads to good outcomes. In other words, for experts a sequence of correct interest rate decisions would already be a good indication for technical expertise of the central bank's staff.

While the information content of an inflation forecast is relatively limited, there is a risk that its publication can be misinterpreted. A good example is the situation after the ECB's interest rate reduction in April 1999. At that time a conditional inflation forecast based on a short-term rate of 2.5 % for two years ahead would have led to the result that inflation in the euro area will exceed the threshold of 2 %. The publication of this information would have led to a serious confidence crisis for the euro. It would have been very difficult to explain, why the ECB is not increasing interest rates although it forecasts that the inflation target will be missed. The publication of a central bank's inflation forecast also entails the risk of a self-fulfilling prophecy. In a relatively large economy like the euro area, wages are the most important determinant of inflation. Thus, if the ECB makes an inflation forecast, it mainly has to forecast future wage agreements. As soon as it sees a risk of wage inflation and revises its forecast upwards, it is very likely that trade unions will base their negotiations on that forecast so that it will materialise.

5.5 No empirical evidence for positive effects of inflation targeting

In sum, it seems not very likely that by adopting the procedures of the Bank of England, the ECB or the Fed would substantially enhance the ex-ante accountability of their policies. This conclusion is supported by the lack of empirical evidence in favour of inflation targeting. In their comprehensive study Bernanke et al. come to the result:

“Inflation targeting has had important benefits for the countries that have used it. Inflation-targeting countries have achieved lower inflation rates and lower expectations; they experience less ‘pass-through’ into the inflation rate of shocks to the price level; and they typically enjoy lower nominal interest rates as a result of lower inflation expectations.” (Bernanke et al. 1999, p. 6)

But upon closer scrutiny the benefits are much less clear-cut. Even strong supporters of inflation targeting like Bernanke et al. have to concede:

“Overall, though, we must admit that the economic performance of the non-targeters over the period considered is not appreciably different from that of inflation targeters.” (Bernanke et al. 1999, p.283)

Lane and Van Den Heuvel (1998) and Jonsson (1999) come to rather similar results. Johnson shows that inflation has become less volatile after the introduction of inflation targeting, but the same effect can be observed in many other industrial countries. Neumann (2000) compares actual inflation rates with inflation targets. He shows that the United Kingdom and Germany were most successful in reaching their targets while in the other inflation targeting countries major divergences between their targets and final outcomes can be observed.

Another serious problem for an assessment of inflation targeting is the fact that all inflation targeting countries have adopted this strategy after they had already regained low inflation rates. Thus, there is no evidence on the contribution of inflation targeting in a disinflation process. And because of the still rather short experience with inflation targeting it is also not possible to assess its functioning in a period of a world-wide inflation surge.

All in all, there is so far no empirical proof that inflation targeting has positive effects on the transparency, accountability and thus on the credibility of monetary policy.

6. Implications for the ECB

This sceptical assessment of the merits of inflation targeting does not mean that the ECB should sit back and leave its “stability oriented monetary policy” as it is. As already mentioned, as a first step it would be advisable to reduce the role that this strategy it is attributing to the money stock M3 as a “reference value” for monetary policy. Without a monetary pillar, the ECB’s strategy would be transformed in a one pillar approach. This would require that the “broadly based assessment of the outlook for future price developments” obtains a more coherent and thus a more solid structure than now.

A revamping of the ECB’s strategy should above all be guided by an attempt to strengthen the ex-ante accountability of its policy. A statement by Issing (1999, p. 16) indicates that so far the ECB has not paid enough attention to this forward-looking dimension of accountability:

“For purposes of accountability and providing an anchor for expectations, it is important to provide a quantitative definition of price stability and to emphasise that price stability will be maintained over the medium-term. I do not believe, however, that it is necessarily helpful to go further and create the impression that monetary policy, by itself, would be able to ‘fine-tune’ price developments at a certain horizon and to do so on the basis of inflation targeting alone.”

While we share Issing’s sceptical tone about the usefulness of publishing inflation forecasts, it seems nevertheless important to enhance the forward-looking dimension of the ECB’s accountability.

6.1 The role of private inflation expectations

The basis for a revised “stability oriented monetary policy strategy” are *private inflation expectations*. The so-called *expectations channel* of monetary policy transmission⁷ shows that private inflation expectations can be regarded a very important determinant of future inflation, above all in a relative large economy like the euro area (Finger 2000). In fact, several central banks provide intensive information on different indicators of such expectations. Four different groups of indicators can be distinguished:

- Surveys of the results of inflation *forecasts* made by *professional researchers*. For instance, the ECB has conducted a quarterly survey of inflation expectations in the euro

⁷ See Bofinger et al. (1996) and Svensson (1997).

area: the Survey of Professional Forecasters (SPF).⁸ It publishes the SPF together with other survey-based indicators of future price developments (e.g. from Consensus Economics). Compared with a central bank forecast, such surveys have the advantage of providing a better diversification of different models and different judgements. As far as the availability of data is concerned, all important data are published in a timely manner so that the central bank has no substantial lead over other researchers.

- Surveys of inflation *expectations* of households, managers, trade union officials. Such data are published eg by the Reserve Bank of Australia or the Bank of England.
- Indicators of inflation expectations which are derived from *financial market* data, above all long-term bond yields and the difference between such yields and the yields of index-linked gilts.
- In addition, the results of *wage settlements* can be used as very important indicators of inflation expectations and of future cost pressure. The recent wage settlements in Germany that even cover the next two years are a very clear indication that the inflation risks will remain very limited.

6.2 A simple rule for monetary policy

Compared with the highly complicated process of producing an internal inflation forecast, a comprehensive survey of inflation expectations provides a relatively simple rule for monetary policy which can be used for internal decisions as well as for the dialogue with the public. As long as inflation expectations are identical with the inflation target, the risk of missing the inflation target is relatively low, especially if the currency area is relatively large so that it is not very much exposed to the disturbances of exchange rates. If expectations diverge from the target, there is a strong indication that the central bank has to change interest rates.

Such a simple framework would create an effective external constraint on a central bank's discretion. It allows an objective, permanent and timely evaluation of a central bank's policy. If the outside forecasts diverge substantially from the target, a central bank gets under a strong pressure to justify this evaluation and eventually to adjust its interest rates. This constraint on a central bank's discretion is especially powerful, if a central bank (like the ECB) is obliged to report regularly to the parliament.

⁸ For details see ECB (2000, p. 28): "The inflation expectations obtained from the SPF are based on the responses to a questionnaire submitted to a sample of 83 forecasters throughout the EU. Respondents are asked to provide estimates of the expected rate of change in the euro area HICP, looking one and two years ahead. Once a year, in February, the SPF also requests expectations for five years ahead."

This use of inflation expectations in a simple rule does not imply that the central bank has to react mechanistically to inflation expectations. In the same way, as the proponents of monetary targeting always envisaged the possibility of a deviation as long as the central bank can convincingly justify it, a rule based on inflation expectations could always be suspended as long as the central bank can provide a good explanation for such a procedure (Bernanke and Woodford 1997, p. 682)

A central bank's testimony on private inflation expectations would show at a very early stage whether a deviation between expectations and target

- is due to a temporary demand or supply shock to which the central bank does not want to react because of its medium-term orientation,
- has been caused by one-time effects like an increase in value-added taxes,
- is the result of an inadequate interest rate policy (and expectations of such a policy) which would require a correction, or
- can be explained by a difference between the central bank's forecast and outside forecasts.

The last situation is the only situation where it would really make sense for the central bank to publish its own forecast. It would require that the central bank is convinced that the outside forecasts are obviously flawed.

6.3 The ECB is already on the right track

All this could be relatively easily implemented by the ECB. As already mentioned, the ECB's Monthly Bulletin already reports on private inflation expectations. This should be done in a more systematic and more regular manner. Above all, these data and their analysis would require a much more prominent position in the Bulletin. Instead of starting with a boring description of monetary aggregates and credit growth, the ECB should begin its Bulletin with a survey of inflation expectations and if necessary an explanation for deviations from the target. As currently all surveys and financial market data clearly indicate that inflation will remain close to the 2 % threshold, the ECB would have been well advised to make this much more public than it does now. Especially in the last few months such an offensive approach would certainly have contributed to a better standing of the euro not only on international

financial markets but also in the public opinion. Of course a central bank has always to be very vigilant as far as inflationary risks are concerned, but the ECB would certainly need somewhat more self-assurance.

In sum: What the ECB can learn from inflation targeting is the need to base its accountability on a more forward-looking perspective. But instead of placing its own conditional inflation forecast in the centre of this process, it should use private inflation expectations in relation to its inflation target as a simple rule for its own decisions as well as for its dialogue with the European public and the European Parliament.

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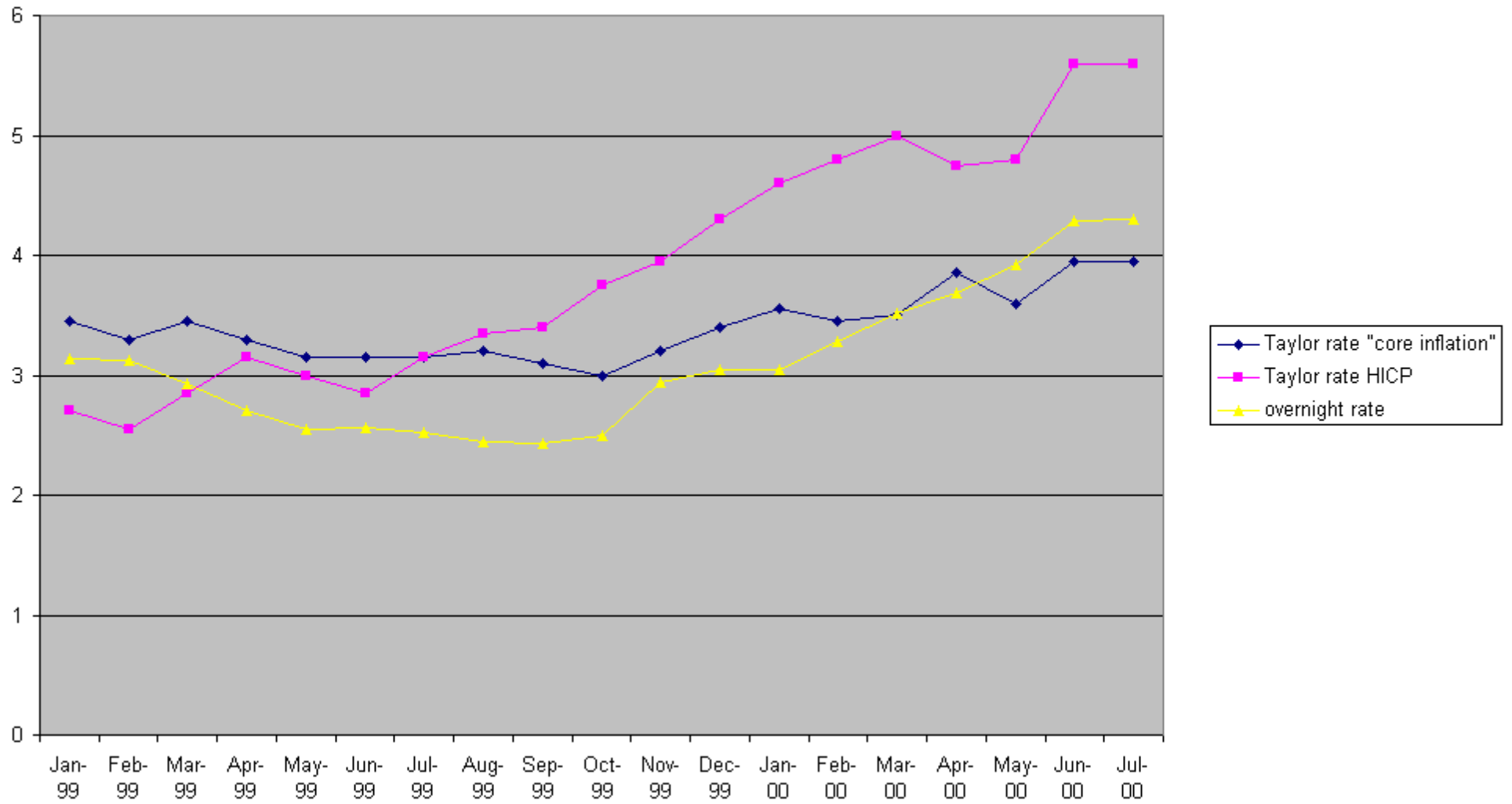
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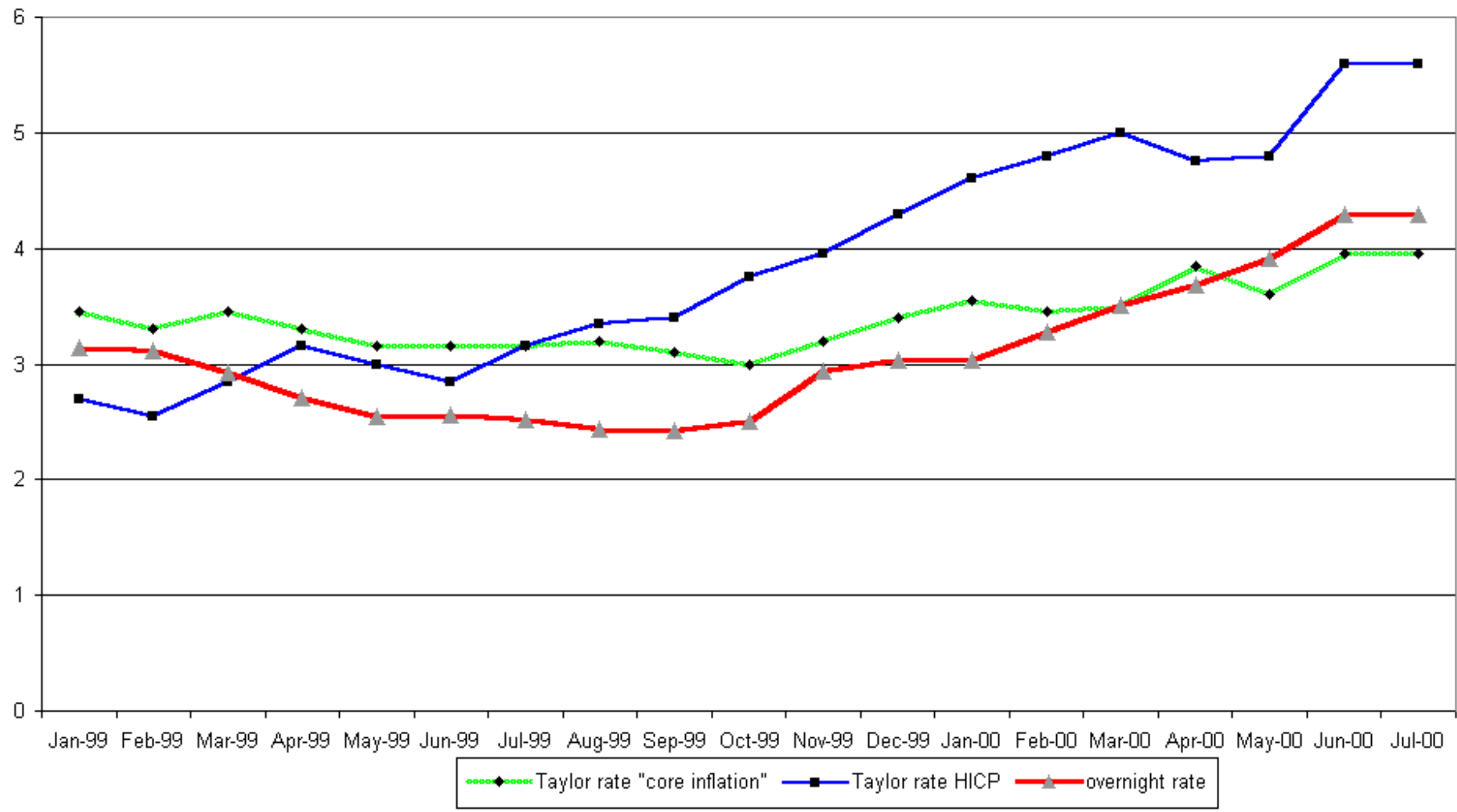
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Taylor rule for the euro area





Source: European Central Bank

Kurzfristige Zinsen

