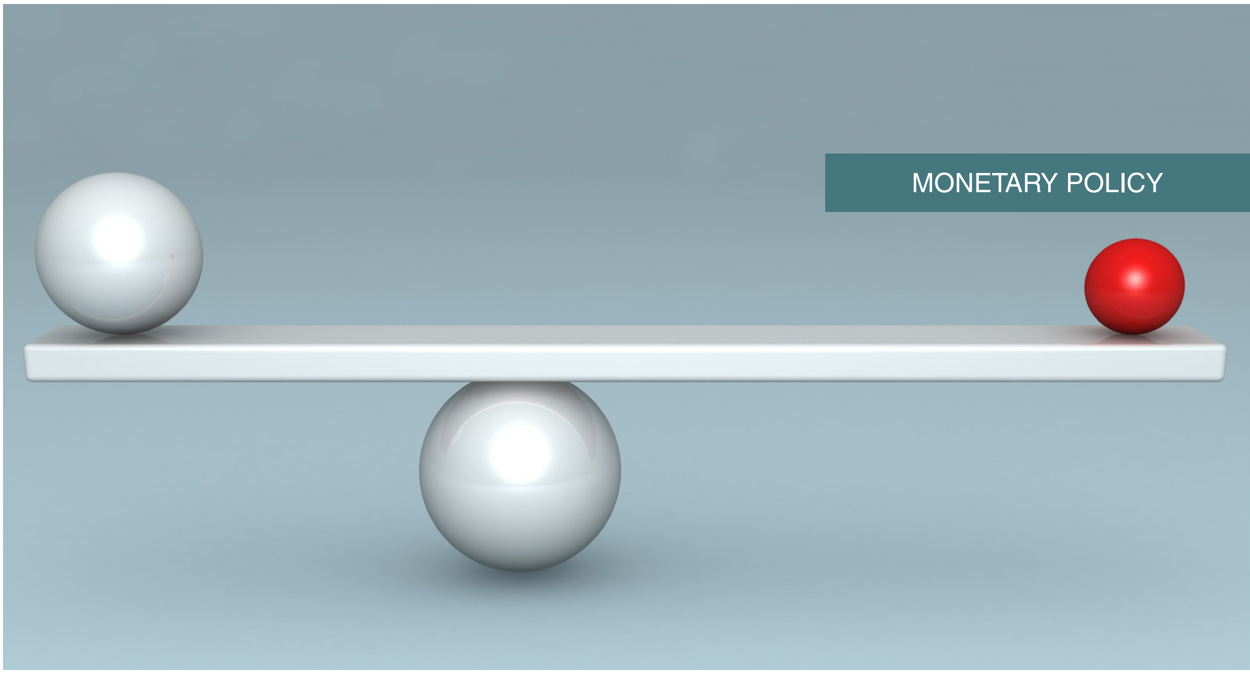

Forward guidance and price stability: The European Central Bank seeks to chart a clearer path

The European Central Bank's unconventional monetary policy stance has bred some confusion among euro area member states, especially over its definition of price stability. While the bank may not be able to eliminate all ambiguity, by advocating monetary integration, the ECB is working to improve the functioning of Europe's economic and monetary union and strengthen its forward guidance on monetary policy.

Erik Jones

Abstract: By advocating monetary integration and through efforts to strengthen forward guidance, the ECB seeks to improve how Europe's economic and monetary union functions. However, the politics and economics of the ECB's unconventional monetary posture has bred confusion, much of which likely stems from the ambiguity surrounding the definition of price stability. Europe's unique economic and monetary union —and the diversity of the member states that have adopted the euro as a common currency— have spawned divergent policies and perspectives on price stability, some of which have been aired publicly by members of the Governing Council. As a rules-based institution, market

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participants need to know well in advance what the ECB is planning and which direction its monetary policy is heading. To provide more clarity, the Governing Council could promote financial market integration within the euro area, encourage market-structure convergence and construct a narrative that explains how prices can be stable for the euro area as a whole despite obvious differences in national inflation rates. While the ECB may not be able to eliminate all the ambiguity surrounding price stability, its efforts to construct a more cohesive monetary union can produce more effective monetary policymaking, both in perception and reality.

Introduction

The European Central Bank (ECB) has worked hard to strengthen its 'forward guidance' as the Governing Council makes key decisions to wind-up the bank's unconventional monetary posture. The goal of the policy is to ensure that market participants know well in advance both what the ECB is planning and how the Governing Council will make its decisions. However, judging from a press conference held in December 2018, this forward guidance is not working very efficiently. In an exchange following ECB President Mario Draghi's opening statement, a journalist asked how quickly the bank would slow the reinvestment of maturing assets on its balance sheet once it started raising interest rates. Draghi seemed intent on leaving the possibility open for the bank to engage in another round of long-term refinancing operations (LTROs). [1] Any slowdown in the pace of reinvestment would shrink the balance sheet of the ECB, while additional LTROs would help keep that balance sheet closer to its current size as existing loans mature. If the ECB's forward guidance was working efficiently, the ECB and the markets would not be facing in opposite directions.

The gap between these two perspectives is significant. The ECB set the direction for progressive monetary tightening when it began cutting back on its net purchases of marketable securities within the large-scale asset purchasing programme in October 2017. [2] Now, market participants are asking, "Are we there yet?" while Draghi continues to repeat that the policy is both date and state contingent. At one point he even said, "We may well never get there." Draghi has good reason to be cautious. Both the politics and the economics of unravelling the ECB's unconventional monetary posture are more confusing than they first appear (Jones, 2017). When market participants ask how quickly the ECB will normalize interest rates, for example, they shine a light on the policy disagreements that different members of the Governing Council have already made public. And when Draghi urges caution, he reveals the complex interactions between the unconventional settings of standard monetary policy instruments.

However, policy disagreements and technical complexity aside, the two sides at the press conference were still facing in opposite directions. Moreover, there is good reason to believe that much of the confusion derives from the ambiguity surrounding the ECB's definition of price stability, both conceptually and in terms of market perceptions.

That ambiguity comes from two different sources: Europe's unique economic and monetary union and the diversity of the member states that have adopted the euro as a common currency. Since the ECB is a rule-based institution, both the ambiguity and the confusion it generates are significant. The ECB cannot have efficient forward guidance if it is not clear to market participants which direction its monetary policy is going. Given that the ECB's notion of price stability is inherently

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Europe's unique economic and monetary union

Europe's economic and monetary union is unprecedented in many ways, but three features are uniquely relevant to the conduct of monetary policy. First, the ECB's mandate focuses narrowly on price stability. [3] The ECB has other considerations related to the support it provides for the European Union's broader policy objectives and to the management of exchange rates relative to other global currencies. However, those interests are subordinate to price stability and the ECB has broad discretion in deciding when those other objectives should influence the decisions of the Governing Council. In practice, successive ECB presidents have made it clear that achieving price stability is a contribution the bank can make to other EU objectives and to the relationship between the euro and other currencies.

The second aspect is that the ECB's Governing Council has the power to define price stability and hence to specify its own policy objective. This authority reflects the fact that monetary integration is a work in progress. The creation of a multinational currency implied the creation of new statistical aggregates to measure the movements in relative prices across countries and to capture the growth and distribution of different kinds of liquidity (or monetary instruments). It also implied the creation of a new monetary transmission mechanism through which policy decisions made in Frankfurt could impact financial conditions in participating countries. Hence, the assumption was always that the ECB's Governing Council would learn how to control Europe's monetary economy on the job. The discretion the Governing Council has over the specification of price stability was necessary to allow the ECB to adapt with experience.

Third, the Governing Council of the ECB recognized explicitly that the way it shaped market perceptions of price stability was critical both to the creation of the single currency and to the functioning of monetary policy. By highlighting the new price indexes and monetary aggregates, the Governing Council underscored that the euro area had one mass of liquidity, one monetary policy and one monetary transmission mechanism, even before the euro existed as a common currency. The Governing Council also worked hard to create one strategy for communication with financial market participants and other European institutions. This communication was not always disciplined, however; national central bank governors retained privileged access to their domestic political and market constituents and often discussed national economic conditions in ways that complicated

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the messaging of the Governing Council and the ECB. Nevertheless, the ECB Executive Board, and the ECB President, quickly emerged as the most authoritative voices for the euro area.

Defining price stability

Successive Governing Councils have supported a notion of price stability with constructively ambiguous targets — constructive in the sense that they have helped foster a sense of common enterprise across the euro area, and ambiguous because they have created space for competing interpretations. However, this ambiguity was not immediately apparent. When the Governing Council first announced its definition of price stability in October 1998, for example, the 2% ceiling captured the most attention, followed by the absence of a lower bound. "Price stability," the announcement read, "shall be defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2%". [4] The qualifications that followed this statement proved to be more important to how the Governing Council conducted monetary policy in practice. Although the statement referred to year-on-year price movements, the rest of the announcement made it clear that the policy goal was to influence medium-term expectations, that the relevant measure was the aggregate across the euro area and that the Governing Council would rely on developments in monetary aggregates and macroeconomic performance to shape its decisions using a reaction function that would evolve over time.

Moreover, each time the Governing Council changed its specification of price stability, these qualifications became more important to the conduct of monetary policy. The Governing Council progressively widened the gap in its scheduled policy deliberations to allow more time for relevant changes in macroeconomic and monetary conditions. It also abandoned the practice of announcing the reference point for measuring the growth of monetary aggregates; strengthened the lower bound for price movements by adding that annual aggregate inflation should be less than but close to 2%; established the medium-term as a five-to-ten year time horizon; and began to talk about the dispersion of national inflation rates (and the importance of some kind of conditional convergence across participating countries). [5] Finally, the Governing Council made it clear that the relevant expectations should operate without the influence of monetary accommodation; in other words, price stability only exists if prices remain stable without the support of the ECB. As Draghi explained in December 2017, "The issue here is more how strong is the convergence path towards a self-sustained and sustainable inflation rate which is close to but below 2% in the medium term". [6]

These qualifications often make it difficult for market participants to anticipate where the Governing Council stands on its policy objective, even when the ECB's estimates for current and expected aggregate inflation are known. This is why the ECB's communication strategy is so important — it helps to cut through ambiguity both in terms of how the Governing Council sees current conditions and how it expects to react to underlying and expected developments. The 'chained guidance' on how the Governing Council expects to unwind its unconventional monetary stance is a case in point. [7] ECB President Mario Draghi has explained repeatedly how and when different policy decisions will be taken and under what conditions they will be implemented. The message received in the markets nevertheless remains vague in important respects.

One currency, different perspectives

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This is not so much a standard critique of a one-size-fits-all monetary policy, but rather an acknowledgement that the way market participants perceive the ECB and interpret its actions on monetary policy tends to differ from one national context to the next. Some of these differences emerge from competing policy traditions or paradigms. While the German economic community accepts the existence of downward wage and price stickiness, for example, it has little confidence in the existence of an exploitable Phillips Curve that would allow policymakers to trade inflation for unemployment. Instead, German economists pay more attention to the way wage bargaining institutions tend to institutionalise expectations. Hence, the Bundesbank has a long tradition of monetary targeting with the goal of establishing credibility among wage negotiators. The traditions of monetary thought and policymaking are very different in France, where Keynesian-style aggregate demand management has been more prominent. [8] The two policy rules used by the ECB encompass both interpretations.

Differences in national institutional arrangements also create differences through a form of 'bounded rationality'. Labour markets provide an obvious illustration. The German pattern of monetary policymaking works well when labour market institutions promote coordinated wage bargaining, but is less effective in encouraging price stability when wage negotiations are less coordinated and more conflicting (Hall, 1994). A similar point applies to financial markets. Where firms rely on patient capital from longer-term investors or stable bank-firm relations, it is easier for policymakers to focus on the evolution of large monetary aggregates; where firms rely on alternative sources of financing and where firm-bank relations are more flexible or arm's length, the influence of monetary policy is not the same (see, for example, the introduction to Hall and Soskice, 2001).

A third difference is behavioural and reflects what central bankers refer to as 'Goodhart's Law', after the British economist and central banker Charles Goodhart. What Goodhart observed is that macroeconomic relationships cease to have predictive value once their use as policy instruments is known to market participants, who immediately build their reactions to movements in key variables into how they formulate their expectations. [9] In practice, Goodhart argued that by targeting price stability using a monetary rule, the ECB effectively reduced the usefulness of that monetary rule in predicting the rate of inflation. The assumption underpinning Goodhart's Law is that market participants all focus on the same thing. However, given different policy traditions or ideas and different institutional contexts, it is more likely that market participants across the euro area will be looking at different facets of what the Governing Council is doing. As a result, the expectations in different parts of the euro area do not rest on the same calculations, and perceptions of the direction of monetary policy should be expected to diverge. [10]

These differences in perspective are less significant when European financial markets are tightly integrated, and large market participants can influence financial conditions across the monetary union. In such a context, the standard critique that the ECB conducted a one-size-fits-all monetary policy that was not appropriate anywhere did not really apply (see Jones, 2009a). It was true of course that local conditions varied and that even a well-functioning monetary transmission mechanism worked differently from one country to the next (and depending on the finance structure). Nevertheless, the Governing Council succeeded in bringing

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the monetary economy of the euro area closer together and creating a sense of unity with diversity for euro member states (which is what made the ambiguity in the definition of price stability 'constructive').

When European financial markets disintegrated during the crisis and the monetary transmission mechanism was impaired, these differences in perception became more important. The Governing Council lost influence over monetary conditions in different parts of the euro area and perceptions of the role of the ECB diverged (see Jones, 2009b). Moreover, despite the efforts of the Governing Council to repair the monetary transmission mechanism and encourage the (re-)integration of European financial markets, this divergence remains significant. The same policy stance relative to the same macroeconomic aggregates is interpreted differently across participating countries.

Conclusions

The ECB may not be able to completely eliminate the ambiguity around price stability. Given that the concept has too many necessary qualifications and perceptions of what the Governing Council is and should be doing, it will always vary depending on the local institutional context. The ECB's forward guidance should also therefore be subject to challenge and interpretation.

Nevertheless, it is possible for the Governing Council to reduce this cognitive dissonance by promoting financial market integration within the euro area, encouraging market-structure convergence, and constructing a narrative to explain how prices can be stable for the euro area as a whole despite obvious differences in inflation rates from one country to the next. Unsurprisingly, this is exactly what the members of the ECB Executive Board have been doing in their many speeches, press conferences and other forms of public outreach. By advocating monetary integration, they seek to improve the functioning of Europe's economic and monetary union and strengthen their forward guidance on monetary policymaking. While they may not be able to eliminate all ambiguity, their efforts to construct a more cohesive monetary union can improve the effectiveness of the ECB's monetary policymaking, both in perception and reality.

Notes

[1] This press conference took place on December 13th, 2018. The transcript can be found here: https://www.ecb.europa.eu/press/pressconf/2018/html/ecb.is181213.en.html

[2] The actual draw down started in January 2018; the announcement was made in October 2017. The transcript of that announcement can be found here: https://www.ecb.europa.eu/press/pressconf/2017/html/ecb.is171026.en.html

[3] See Article 2 of the Statute of the ECB, the full text of which can be found here: https://www.ecb.europa.eu/ecb/legal/pdf/c_32620121026en_protocol_4.pdf

[4] This announcement was made at the October 13th, 1998, press conference, the transcript for which can be found here: https://www.ecb.europa.eu/press/pressconf/1998/html/is981013.en.html

[5] The most important revision took place in May 2003 and is captured in a press seminar on the ECB's evaluation of its monetary policy that can be found here: https://www.ecb.europa.eu/press/pressconf/2003/html/is030508_1.en.html

[6] The question was whether 1.7 percent was 'close to' 2 percent. The press conference took place on December 14th, 2017, and can be found here: https://www.ecb.europa.eu/press/pressconf/2017/html/ecb.is171214.en.html

[7] The phrase 'chained guidance' comes from the minutes of the December 2018 policy meeting and can be found here: https://www.ecb.europa.eu/press/accounts/2019/html/ecb.mg190110.en.html

[8] For an extended treatment of this comparison, see Brunnermeier, James and Landau (2016).

[9] Goodhart used this critique to challenge the role of monetary aggregates in the ECB's policy framework. See Goodhart (2006).

[10] Goodhart argues that in such situations monetary policy becomes more effective (even

if less well anticipated by market participants): It is a corollary of Goodhart's Law that variables that become the cynosure of policy lose their predictive value, whereas variables that are no longer treated as policy measures may regain predictive value.' See Goodhart, 'The ECB and the Conduct of Monetary Policy, p. 771.

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Erik Jones. Director of European and Eurasian Studies and Professor of European Studies and International Political Economy at the Paul H. Nitze School of Advanced International Studies

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