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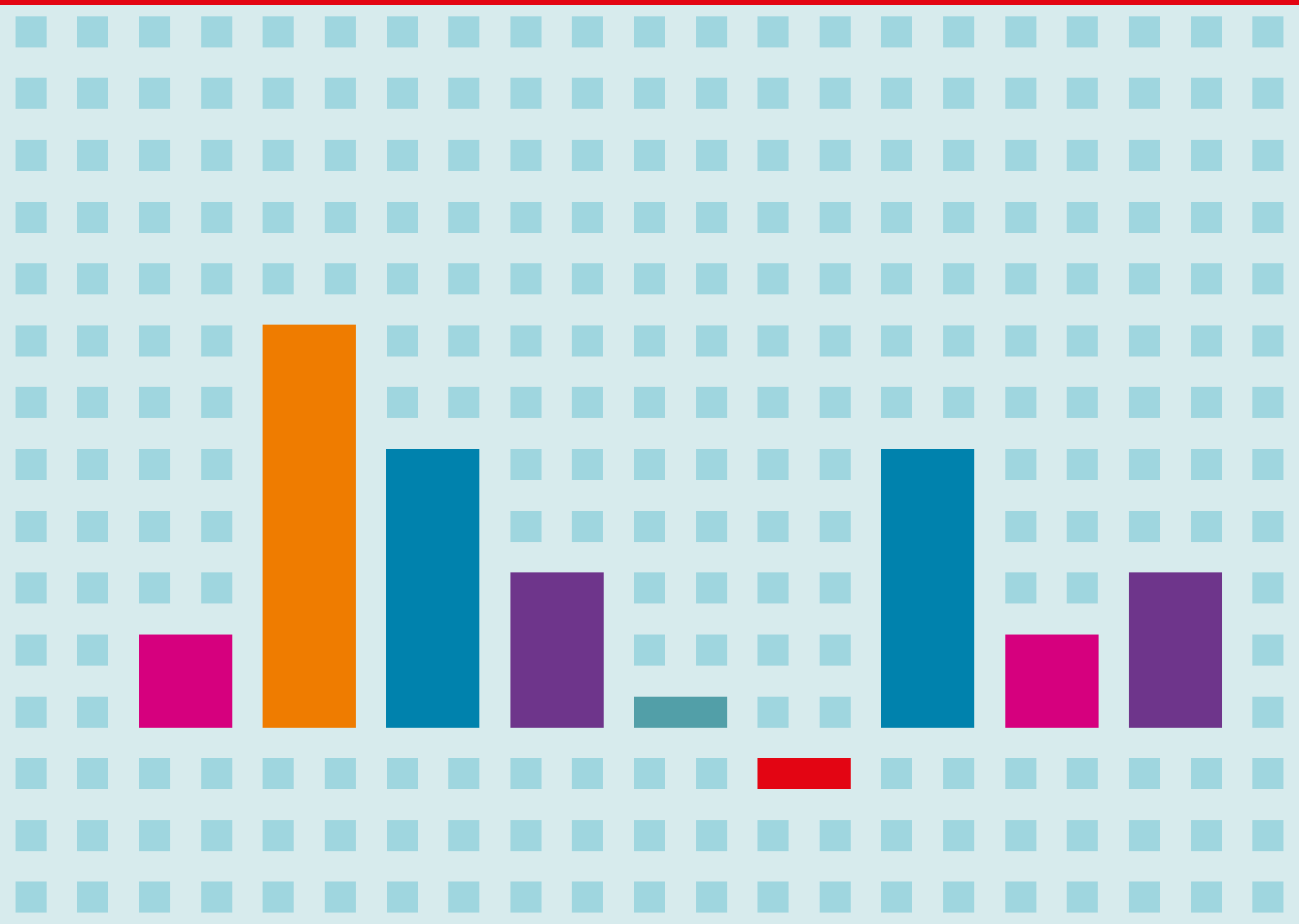
Sebastian Dullien, Silke Tober



ECB STRATEGY: BEST PRACTICE AND NEW FRONTIERS

Sebastian Dullien[1], Silke Tober[2]

Summary

The ECB's strategy of inflation targeting as currently practiced requires only minor adjustments to allow the ECB to best provide price stability and support the EU's general economic policies. The key to inflation targeting is a distinct and symmetric inflation target that serves as a benchmark for private-sector expectations and a central bank that is held accountable and transparently justifies its policy actions. As one of only two macroeconomic policies, the remit of monetary policy is not limited to its primary objective of price stability. Preventing or reversing labor market hysteresis should factor into monetary policy decisions as should climate change considerations. In contrast, the lack of owner-occupied housing services in the HICP is often overstated and might lead to the potentially detrimental inclusion of asset prices in the inflation measure. A political solution to the euro area's safe asset problem – outside the ECB's remit – would facilitate monetary policy, increase the overall resilience of the euro area and bolster the international role of the euro.

[1] Prof. Dr. Sebastian Dullien, Research Director, Macroeconomic Policy Institute (IMK) Sebastian-Dullien@boeckler.de.

[2] Dr. Silke Tober, Head of Monetary Policy Research, Macroeconomic Policy Institute (IMK) Silke-Tober@boeckler.de.

1 Introduction

Since its previous strategic review in 2003, the ECB has made substantial progress in adjusting and refining its monetary policy strategy of inflation targeting. The ECB acts in a forward-looking manner, clearly articulating its objectives and policies in numerous reports, speeches, meeting accounts, and press conferences. During the presidency of Mario Draghi, the ECB's inflation target evolved into a symmetric target and the ECB began to incorporate hysteresis effects into its monetary policy deliberations.

The gradual shift in the way the ECB conducts and explains its monetary policy reflects the recent tectonic shift within mainstream macroeconomics. Keynesian arguments that were widely dismissed a mere ten years ago have gained traction and are now advocated by central banks like the Federal Reserve and international organizations like the International Monetary Fund (IMF) and the Organization for Economic Cooperation (OECD). In particular, it is now widely recognized that a rise in short-term unemployment may translate into higher long-term unemployment and underemployment (Blanchard/Summers 2017, Draghi 2014, Logeay/Tober 2006) and that fiscal policy has an important role in macroeconomic stabilization.

The ECB has vowed to "leave no stone unturned" as it scrutinizes its policy instruments and aims, various aspects of the inflation target as well as the ECB's communication with governments and the public at large (Lagarde 2020a). In this policy brief, we argue that the strategy of flexible inflation targeting as currently practiced by the ECB requires only minor adjustments to best allow the ECB to provide price stability and support the EU's objectives of high employment and sustainable growth. Section 2 reviews the mandate of the ECB as laid down in the EU treaties. Section 3 discusses the importance of a symmetric inflation target as a benchmark for private-sector expectations, the role of core inflation as an indicator of underlying inflation, and the inadequacy of including house prices in the inflation measure. Section 4 addresses the advantages of flexible inflation targeting in a world where potential output is both empirically elusive and endogenous to monetary policy. Section 5 argues that the lack of safe sovereign bonds in the euro area handicaps monetary policy, exposes the euro area to substantial financial instability risk, and undermines the Commission's aim of strengthening the international role of the euro. A political solution to the safe-asset problem would allow the ECB to reposition its refinancing operations towards open market operations as practiced by the Federal Reserve and thereby increase the overall resilience of the euro area. Section 9 concludes by stressing the need for macroeconomic policy coordination and cautioning that the current improbability of runaway inflation is not a given but rather hinges on the ECB's commitment to price stability.

2 The ECB's mandate: a macroeconomic perspective

Although often disputed, the mandate of the ECB is quite similar to that of the Federal Reserve and other independent central banks. Unlike the Fed, the ECB does not have a dual mandate but rather the primary objective of low inflation that outranks other aims such as low unemployment and high sustainable growth. However, this does not imply that ensuring stable and low inflation is the ECB's sole mandate. Price stability is the ECB's primary objective because high inflation negatively affects economic stability and employment, not because low inflation is a key objective

in itself. As one of only two macro policies that can effectively be employed to stabilize the economy, monetary policy is also responsible for ensuring sufficient aggregate demand in the euro area with a view to high employment and growth, albeit only to the extent that this is compatible with the ECB's inflation target.

Generally, economic slack and subdued inflation go hand in hand. Therefore, targeting inflation generally also targets low unemployment. If the objectives of low inflation and low unemployment conflict – for example in a boom or a period of stagflation – inflation has higher priority for the ECB. The hierarchical structure of policy objectives is expedient from a macroeconomic perspective because high inflation would benefit employment in the short run at best, but would eventually raise unemployment as the central bank increases interest rates to rein in inflation, all the more so if higher inflation becomes entrenched in expectations.

The hierarchy of the ECB's objectives is laid down in the EU Treaties. According to article 127 of the Treaty on the Functioning of the European Union (TFEU), "*the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union"* which include, inter alia, balanced economic growth, full employment, and a high degree of environmental protection *"(s)o far as this can be done without prejudice to the objective of price stability*" (Art. 127, TFEU).

From a legal perspective, it may be tempting to narrow down the ECB's mandate to price stability as evidenced by the ruling of the German Constitutional Court in May 2020 (BVerfG 2020). The German Constitutional Court argues that the ECB's lack of democratic legitimacy and independence requires a strict distinction between monetary policy and general economic policy (BVerfG 2020, 161). If monetary policy impacts general economic objectives, the ECB is compelled to provide detailed analyses showing that the effects of a particular instrument such as bond purchases are "proportional" to reaching the monetary policy objective, according to the German Constitutional Court. Interpreted as an extensive cost-benefit analysis, such a proportionality analysis is valid and can point to risks as well as policy alternatives. For example, the enduring low-interest-rate policy bears considerable financial stability risks (ECB 2019, Theobald et al. 2016), which is a strong argument for fiscal policy to take on a greater share of the macroeconomic stabilization effort. Similarly, corporate bond purchases run counter to the EU's climate commitments and policies because they disproportionately favor large carbon-intensive companies, a stronger focus on green bonds being a potential alternative currently weighed by the ECB (Lagarde 2020d, Schnabel 2020).

In contrast, proportionality considerations combined with an overly narrow interpretation of the ECB's mandate would unduly limit the scope of monetary policy. For example, it is possible to justify including climate change considerations in monetary policy decisions with reference to price level stability. However, such a line of argument appears contrived.[3] Stranded assets and more extreme weather conditions do pose risks for financial stability and economic growth. However, arguing that monetary policy should be greener because of the negative impact of

[3] For example, in February 2020, ECB President Lagarde stated that "within the primary objective, environmental sustainability has an impact and should be factored in, because it has an impact on prices and relative prices, on consumption, on risks anticipated by consumers and by companies and because it forms this aggregate of elements that we have to take into account when we contribute, by our monetary policy, to price stability, which is our key mandate" (Lagarde 2020c, p. 14).

climate change on consumption (Lagarde 2020c) is needlessly roundabout and less intelligible than coherently spelling out the ECB's support of overall EU policies geared towards averting the existential threat of climate change.

Furthermore, the botched euro area crisis in the aftermath of the international financial crisis and the delayed recovery of the US economy as well as the current pandemic-induced crisis have highlighted the importance of fiscal policy for macroeconomic stability. Monetary policy cannot be reduced to policies aimed at price stability and, at times, monetary policy alone is not able to deliver price stability. Currently, it takes both monetary and fiscal expansion to raise euro area inflation to the ECB's inflation target, as already argued by Draghi in 2014.[4] Even without the zero lower bound for nominal interest rates being an issue, fiscal policy may be more effective than monetary policy in certain circumstances because it can increase aggregate demand directly and with more precision by, for example, increasing public investment directed at speeding up the transition to a zero-emission economy.

Monetary and fiscal policy aims will remain intertwined even when economic growth is more vigorous and the inflation target is within reach. Given its responsibilities as laid down in the EU treaty, the ECB will have to exercise caution in raising rates and test the limits of inflation-free growth in an effort to reduce unemployment and underemployment, thereby reversing past hysteresis effects. Furthermore, since EU policymakers have prioritized the reduction in greenhouse gas emissions, the ECB needs to ensure that its policies do not counteract but rather reinforce the EU's climate policies. In the updated monetary policy strategy, the ECB should avoid specifying its own secondary goals and instead emphasize its treaty-based responsibility in furthering EU policy objectives under the provision of reaching its primary goal of price stability.

3 Inflation target: unambiguous and symmetric

3.1 Coordinating role of the inflation target

The advantage of inflation targeting is its flexibility, allowing the central bank to ignore temporary price shocks if second-round effects are unlikely and to disregard potential output estimates that are inherently unreliable and, despite sophisticated methods, reflect little more than the trend GDP.

The key to inflation targeting is that the central bank commits to a specific inflation target, bases its monetary policy decisions on sound inflation forecasts, and coherently communicates its monetary policy analyses and decisions (Bernanke/Mishkin 1997). The ECB's inflation target, redefined in 2003 as "below but close to two percent", is only marginally less asymmetric and cryptic than the initial definition of "below 2%" (ECB 2003, ECB 1998). However, as the strategy evolved over the past 18 years, the inflation target is increasingly interpreted as a symmetric target of 1.9% by the ECB, economists, and others. It is therefore highly likely that the ECB will

[4] „Thus, it would be helpful for the overall stance of policy if fiscal policy could play a greater role alongside monetary policy, and I believe there is scope for this, while taking into account our specific initial conditions and legal constraints" Draghi (2014).

adopt an unambiguously symmetric target,[5] with 2% having several advantages in addition to being a whole number. The arguments for a positive inflation target – the lower bound of nominal interest rates, the underestimation bias in allowing for quality improvements, and the built-in buffer against deflation – remain valid;[6] a higher target rate like 4% as proposed by Blanchard (2018) would add frictional costs and has become less compelling given recent experiences with negative policy rates, the effects of quantitative easing on longer-term interest rates and the rediscovery of countercyclical fiscal policy.

The inflation target requires a specific numerical value to serve as a benchmark for inflation expectations and the inflation component of wage negotiations. Anchored inflation expectations and the use of the inflation target rather than actual inflation in wage bargaining reduce the response of inflation to negative or positive output gaps and temporary price shocks thereby limiting cumulative effects such as price-wage spirals. A specific target is especially important in the euro area because a persistent divergence in inflation between euro countries affects price competitiveness and results in macroeconomic imbalances. Given the common monetary policy, macroeconomic stability in the euro area requires national economic policies and, in particular, fiscal policies to monitor national inflation and, if need be, correct its alignment to the inflation target.

The ECB's decision to base the inflation target on the harmonized index of consumer prices and define it as a medium-term target provides a solid foundation for monetary policy, the ECB's communication, and its accountability. If inflation is likely to fall below the target in the medium term, the ECB loosens the monetary reins; if a sustained overshoot is forecast, the ECB tightens monetary policy. The medium-term perspective provides the ECB with the flexibility it needs – for example, when not reacting to temporary price shocks, while at the same time impelling and enabling the ECB to justify its inflation forecast and policy actions.

3.2 Core inflation as a key indicator

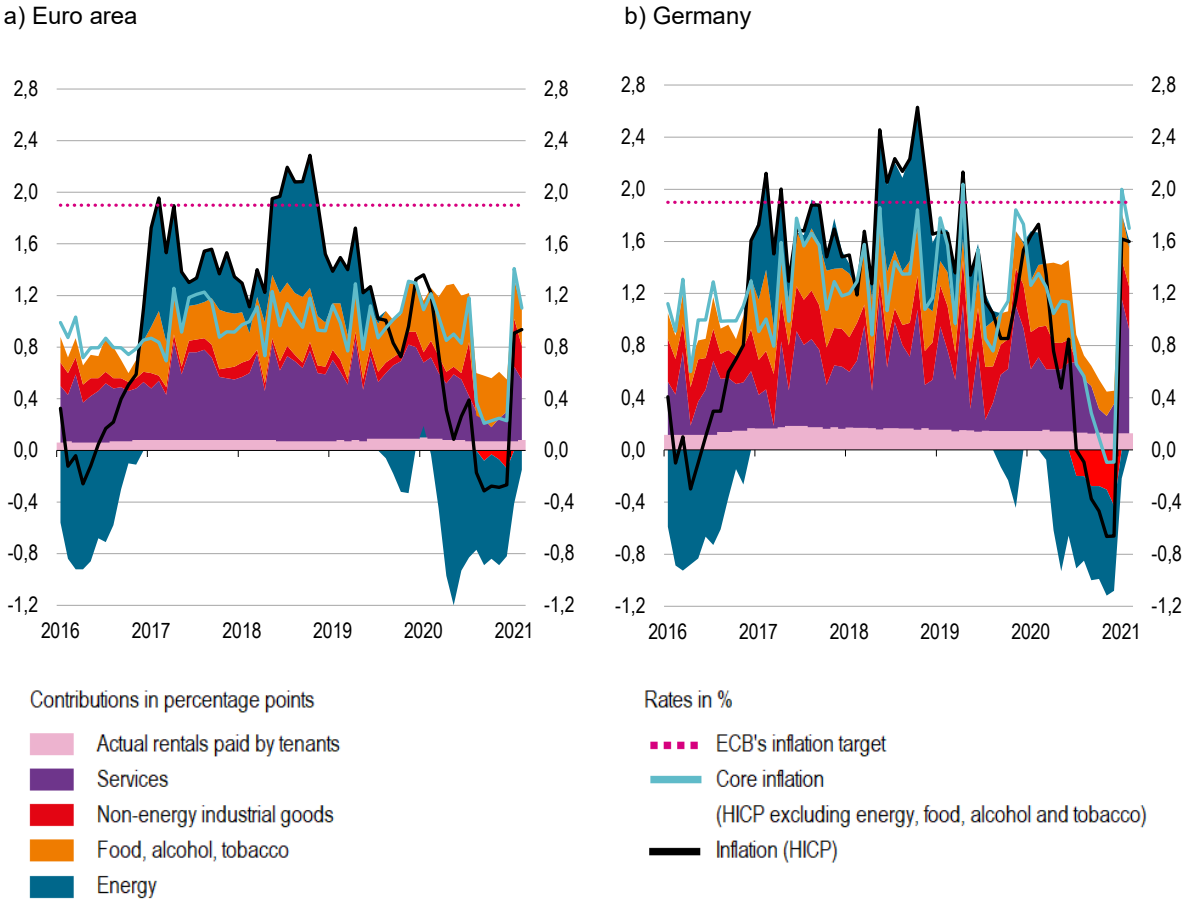
Whereas the medium-term perspective has been an element of the ECB's monetary policy strategy since 2003, the use of core inflation as an important indicator emerged only during Draghi's presidency. Core inflation – the blue line in the chart – is important because monetary policy responses to short-term price shocks such as rising food prices due to crop failures or higher oil prices have only minimal impact, if any, on the prices concerned. Instead, overall inflation dynamics are reined in, leading to lower inflation once the temporary price shock subsides. One-off price shocks do not require a monetary policy response (Tober/Zimmermann 2009). Unless they trigger second-round effects, temporary price shocks are distinct from inflation which is a process kept in motion by a price-wage spiral. Within the framework of the ECB's

[5] In the September meeting of the Governing Council, "it was also emphasized that the ECB's inflation aim was symmetrical and that the Governing Council would respond with the same determination to sustained downside deviations as to sustained upside deviations from the inflation aim" (ECB 2020).

[6] The asymmetry is a legacy of the Bundesbank – a *de facto* inflation targeter (Bernanke/Mihov 1997, Mishkin 1999). The Bundesbank had an implicit inflation target as one component of its monetary target, which it referred to as the "*unavoidable price level increase*". The implied preference for zero inflation is still widespread in Germany and was recently echoed by a group of economists including the ECB's first chief economist and former Bundesbanker, Otmar Issing (Issing et al. 2019).

strategy of targeting a specific inflation rate – after the current review presumably 2% - in the medium term, core inflation serves as an indicator for underlying inflation.

Chart 1: Inflation and contributions to inflation in the euro area
percentage points (contributions), % (rates), January 2016 – February 2021



Source: Eurostat, IMK calculations.

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3.3 Housing prices as a measure for macroprudential, not monetary policy

A key difference between the Harmonised Index of Consumer Prices (HICP) and national consumer price indexes is that the latter often include imputed prices for owner-occupied housing whereas the former does not. Consequently, housing costs have a lower weight in the HICP. For example, the weight of rents and imputed rents of owner-occupied housing is 19.6% in Germany's national consumer price index while tenant rents in the German HICP have a weight of only 9.5% (2020). Tenant rents in the HICP for the euro area have an even smaller weight – 6.2% in 2020 – because the homeownership rate is higher in the euro area as a whole than in Germany. The rationale for excluding owner-occupied housing from the HICP is the lack of consensus about how to measure its cost, the methods ranging from using rents for comparable dwellings as proxies as in Germany and mortgage payments as in Austria or Sweden to net acquisition costs

based on house prices. This lack of consensus is rooted in the hybrid character of occupier-owned housing as both consumption good and capital good. Housing viewed as capital is only of interest to the central bank from a macroprudential, not a monetary perspective (Brainard 2020).

Nonetheless, the current state of affairs where tenant rents are included in the consumer price index whereas the costs of owner-occupied housing are omitted is also unsatisfactory and compromises the comparability of national inflation rates in the euro area. Homeownership rates range from a low of 51.5% of households in Germany to 90.9% in Slovakia and, among the larger countries, 76.2% in Spain.[7] Largely as a result of the different homeownership rates, the HICP weight of rents is only 1.8% in Slovakia and 2.8% in Spain compared with 9.5% in Germany (2020, Eurostat). At the same time, however, it will prove difficult to find proxies for owners' equivalent rents in countries with high homeownership rates. The alternative of including mortgage payments has the drawback of making the inflation measure directly dependent on monetary policy with inflation rising as interest rates climb, in addition to more fundamental conceptual drawbacks (Ahrens et al. 2020).

It is important not to blow the question of including owner-occupied housing out of proportion, thereby undermining trust in the ECB. A point in case is the following statement by ECB board member Yves Mersch (2020): "Rents represent around 6.5% of the basket used for measuring inflation. For many, rents alone or mortgage payments easily exceed a third of their take-home pay." The fact is that rents represent 6.5% because that is their weight in the average consumption basket.[8] Of the households sheltering in owner-occupied housing in the euro area, 58% have no outstanding mortgages or house loans.[9] Furthermore, rents or mortgages are only one component of overall housing-related costs. The HICP covers the other components for both tenants and homeowners, i.e. (minor) maintenance and repair of the dwelling, water supply, sewage and refuse collection, etc. as well as electricity, gas, and other fuels. Together these components have a weight of 9.5% in the euro area HICP (2020) so that housing-related items have a combined weight of 16% in the euro area and 23% in Germany due to the latter's larger share of rent-paying tenants.[10]

Residential real estate is an asset that generates a stream of housing services. It is the price of the latter that HICP should capture, not the price of the asset itself. If the owner-occupied housing (OOH) index provided by Eurostat is incorporated in the ECB's inflation measure, it would imply that the ownership of a primary residence is viewed as a consumption good. In that case, a primary owner-occupied residence would be treated as a long-lasting durable consumer good. The key difference to most other items in the consumer price index is that the price of real estate tends to appreciate and does not primarily reflect the cost of inputs, i.e. labor and construction

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7 Eurostat data for 2019, Distribution of population by tenure status, type of household and income group - EU-SILC survey [ilc_lvho02].

8 The weight of 6.5% includes rents for garages and secondary residences, the weight of rents paid by tenants was 6.2% in 2020 (Eurostat, HICP item weights).

9 Calculated based on Eurostat data for 2019, Distribution of population by tenure status, type of household and income group - EU-SILC survey [ilc_lvho02]. 65.8 % of households in the euro area are homeowners, 38.4% of households are mortgage-free.

10 Accordingly, the ratio of the weight of maintenance and repair to rentals is 2.4 times higher in Germany's HICP than in the national CPI (14.36 and 94.92, respectively, compared to 12.9 and 207.26).

materials, but rather the scarcity of land (Baker 2018). Although currently, Eurostat is trying to separate the price of land from the price of the building structure, it is unlikely that this will succeed or be transparent. Most crucially, the housing service afforded by an owner-occupied house is not independent of its location and therefore the price of land. Similarly, the rents of otherwise identical houses differ depending on their location. Furthermore, it is not clear what the net acquisition of dwellings in the inflation measure signifies. On the one hand, it indicates the price changes in (net) new dwellings from the perspective of prospective buyers. However, from the perspective of homeowners, a higher price does not represent an increase in costs at all, but rather an increase in wealth. Last but not least, the issue of the weight of the "consumption good" dwellings is not clear cut. It is not as simple as scaling the weight of rents by the proportion of homeowners which would produce a weight of around 9% as stated in Eiglsperger et al. (2018). The weight will depend on the value of net acquisitions – ironically gathered from the gross fixed capital formation in the national accounts (Ahrens et al. 2020) – which, in turn, crucially hinges on the separation of the value of land and building structure.

The call for an inclusion of house prices in the HICP appears, at times, to have the ulterior motive of using the inflation measure to incorporate an element of "leaning against the wind" of asset price movements into monetary policy (Mersch 2020). All approaches to capturing the cost of owner-occupied housing are problematic already at a conceptual level. Including house prices via the net acquisition approach into the HICP raises more problems than it solves and would likely raise the volatility of the inflation measure. The alternative of using owners' equivalent rents is not perfect but it appears to be the least objectionable way of incorporating owner-occupied housing into the HICP and approximating the monthly opportunity costs of shelter for homeowners. Regardless of how owner-occupied housing is accounted for, the resulting higher weight of housing services in the HICP and especially in the core index would warrant a close look at what is driving the price of shelter – rents and the proxy for owner-occupied housing – to determine whether a given rise or fall is relevant for monetary policy.

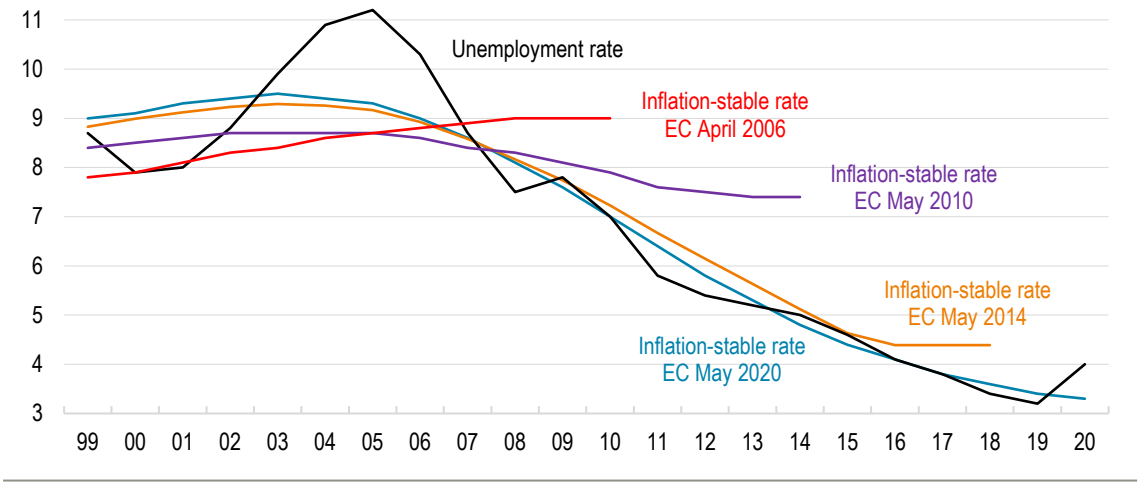
4 Potential output: theoretically compelling, empirically elusive

The current strategy of the ECB is well-suited to deal not only with temporary price shocks but also with the uncertainty of how fast the economy can grow without exerting upward pressure on inflation. Potential output cannot be reliably quantified, in large part because labor market slack is difficult to pin down as both cyclical and structural factors affect key determinants like the participation rate, part-time work, and wage pressure (Yellen 2014). Moreover, potential output is not independent of monetary policy, firstly because the long-term unemployed and disillusioned workers reduce the effective labor supply and, secondly because the monetary policy stance affects investment and thereby the rate of innovation and productivity increase. In his 2014 Jackson Hole speech, Mario Draghi for the first time acknowledged hysteresis effects and the consequent need for monetary policy to react swiftly to economic downturns to prevent short-term unemployment from turning into structural unemployment (Draghi 2014).

Citing the Taylor rule and the Commission's output gap estimates, the German Council of Economic Experts (GCEE) has been calling for monetary policy tightening since 2013.[11] The ECB was wise to disregard the council's advice and pursue its inflation targeting strategy without relying on potential output estimates (Draghi 2018).

Even potential output estimates based on detailed production functions provide time series for potential output that are merely less volatile versions of GDP. As a key component of potential output, the inflation-stable unemployment rate describes the share of the labor force that must be unemployed for growth to be sustainable in the sense of not exerting inflationary pressure.[12] Using different vintages of the Commission's inflation-stable unemployment rate, the charts illustrate that, empirically, the inflation-stable unemployment rate is essentially estimated as a trend based on past and expected actual unemployment rates. Accordingly, empirical analyses have repeatedly shown that wage pressure plays a minor role in the estimation (Horn et al. 2007; Gechert et al. 2016).

Chart 2: Vintages of the Commission's inflation-stable unemployment rate for Germany
in % of the active population



Sources: Spring and Autumn forecasts of the European Commission, CIRCABC Library; Eurostat. IMK

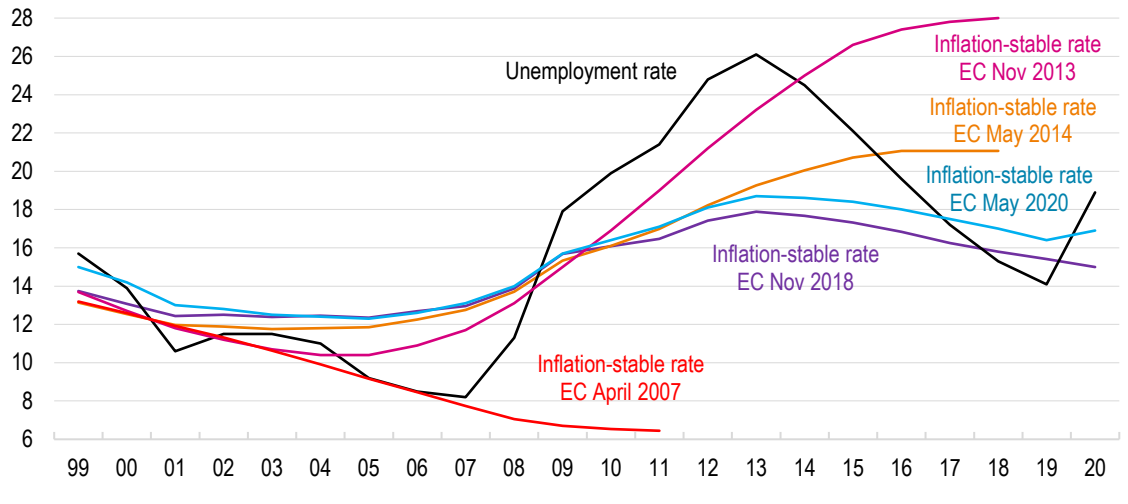
Charts 2 and 3 show that the estimated variable strongly depends on actual and expected developments. For example, according to the European Commission's spring 2020 forecast, Germany's inflation-stable unemployment rate was 3.4% in 2019, while actual unemployment was 3.2%. In 2010, when actual unemployment was 7%, the Commission calculated an inflation-stable

[11] For example, the GCEE asserted in 2016 that "(i)n light of the macroeconomic developments, the extent of the ECB's quantitative easing and the resulting low interest rates are neither appropriate for the euro area nor Germany" (GCEE 2016, p. 2). In 2013, the GCEE called for monetary policy tightening, professing that "(a) rate increase could also be justified with the Taylor rule, which provided a useful sign even before the crisis that the key interest rates had been too low for too long" (GCEE 2013, p. 10).

[12] The inflation-stable unemployment rate is usually referred to as the NAIRU (non-accelerating inflation rate of unemployment). The Commission uses the term NAWRU to highlight the use of the wage rate instead of the inflation rate in the estimation.

unemployment rate of 7.9% for the same year. When actual unemployment rates change, current and past values of the estimated potential rate move in the same direction: From the perspective of 2020, the value for 1999 is more than one percentage point higher than when viewed from 2006 – even though the wage pressure in 1999 has obviously not changed.

Chart 3: Vintages of the Commission's inflation-stable unemployment rate for Spain
in % of the active population



Sources: Spring and Autumn forecasts of the European Commission, CIRCABC library; Eurostat. IMK

The Spanish case is even more daunting. The Commission's 2020 Spring Forecast asserted that Spain's unemployment rate of 14% in 2019 represented an excessively tight labor market. According to the Commission, 16.4% of the Spanish labor force need to be out of work for inflation to be stable and growth sustainable. Almost four million unemployed is in itself an astonishing sustainability requirement. In view of the Spanish core inflation rate – which stood at 1.1% in early 2020, in 2019, and 2018 – it is absurd. Amid the euro crisis in 2013, Spanish unemployment soared to 26.1%. The Commission's estimate in 2013 put the inflation-stable unemployment rate at 23.2% for that year, essentially redefining a cyclical problem as a structural problem. From today's perspective, the inflation-stable unemployment rate for 2013 is 4.5 percentage points lower, the main reason for this revision being the substantial decline in actual unemployment since 2013 that resulted in a flattening of the curve.

The European Commission recently made adjustments in its handling of potential output estimates: Firstly, potential output estimates may now be changed on an ad hoc basis if they appear implausible, an escape clause used extensively in response to the Covid-19-crisis in preparing the Spring Forecast 2020 (European Commission 2020b,c). Secondly, in assessing national fiscal policies, the Commission uses an expenditure path based on medium-term potential growth calculated as a 10-year average as an additional yardstick, and thirdly, the inflation-stable unemployment rate is anchored to a longer-term estimate (Roeger et al. 2019). However, in contrast to current ECB policy, these changes do not represent a fundamental

departure from the empirically inadequate potential output concept and thus continue to obstruct countercyclical fiscal policy.

The US Federal Reserve recently updated its monetary policy strategy to reflect the uncertainties attached to estimates of equilibrium (inflation-stable) unemployment (Powell 2020): The Fed has laid down that it will respond to rising unemployment but not to a decline in the unemployment rate (Federal Reserve 2020). Testing how much growth is possible without an acceleration of inflation has thus become part of the monetary policy canon in the United States.

With a view to transparency and accountability, the ECB should finally call its monetary policy strategy by its name: inflation targeting. The new formulation of its strategy presents a good opportunity for the ECB to explain that inflation targeting allows for the use of a multitude of indicators of inflation, does not rely on inherently uncertain output gap estimates, and provides the flexibility necessary to ensure price stability and support of the EU's general economic policies. Inflation targeting entails the primacy of price stability and is by design forward-looking, allowing the ECB to look through temporary price movements and focus on the trend of underlying inflation. To secure the inflation target as a benchmark for expectations, the ECB should refrain from calling for a period of higher inflation to compensate for the recent years of low below-target inflation. The medium-term perspective provides sufficient room to ignore temporary inflation overshoots while, at the same time, focusing the central bank's attention on identifying underlying trends that may jeopardize price stability.

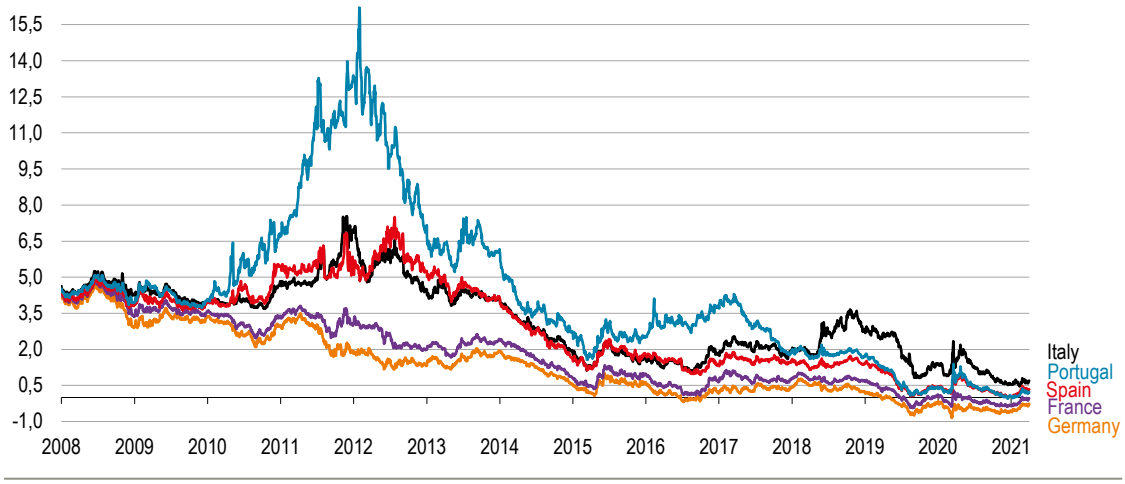
5 Safe assets and the international role of the euro

The key difference between the ECB and the Federal Reserve is not their mandate, but rather the sovereign bond environment in which they operate. In the United States, sound money and safe sovereign bonds reinforce each other as macroeconomic stability anchors. In contrast, the Damocles sword of sovereign default makes the euro area vulnerable to speculative attacks, reduces the effectiveness of monetary policy, increases financing costs for the weakest member states, and inhibits the international role of the euro.

Back in 2010 and 2011, the ECB tried hard to stem a confidence crisis, buying Greek sovereign bonds as early as May 2010. ECB President Trichet strongly opposed sovereign debt restructuring and warned about the instability that would result from confidence loss and contagion risk. However, the Northern governments, anxious about moral hazard and trusting in the disciplinary power of financial markets, were unwilling to offer assurances to restore the safe-asset quality of all euro area sovereign debt and instead pushed ahead with the introduction of collective action clauses to simplify sovereign debt restructuring in the euro area. Risk premiums on government bonds climbed and with them the financing costs for governments and the economy as a whole (Theobald/Tober 2020). In 2014, Draghi rightly attributed the depth of the euro area crisis to "the loss of confidence that constrained many euro area governments' market access" (Draghi 2014) and repeatedly called on euro governments to fix the institutional shortcomings of the euro area. Shortly after taking office, ECB President Lagarde also tried to trigger action where responsibility lay by bluntly stating, "we are not here to close spreads … there are other actors to actually deal with those issues" (Lagarde 2020b) and calling for the introduction of coronabonds (Financial Times 2020), a demand also formulated by groups of economists on

20 March (Regan et al. 2020) and 21 March (Südekum et al. 2020) as well as by nine of the 19 euro area governments on 25 March (Wilmès et al. 2020).

Chart 4: Ten-year government bond yields in selected euro-area countries
in %, daily, January 2008 – March 2021



Source: Macrobond.

IMK

Ultimately, however, it was yet again the ECB that came to the rescue, this time with its flexible and highly effective Pandemic Emergency Purchasing Programme (PEPP). Unlike during the euro crisis, however, the EU and national policymakers also sprang into action, supplementing monetary policy expansion with fiscal relief measures and stimulus packages. Importantly, the EU Stimulus Plan NextGenerationEU boosted confidence in the recovery because the 750 billion euros to be distributed among the member states will be borrowed on international capital markets by the Commission on behalf of the EU. The combination of PEPP and joint fiscal action had a marked impact on yields. For example, the spread between Italian and German ten-year-sovereign-bond yields which had increased to 2 percentage points by 11 March 2020 and 2.8 percentage points 6 days later fell to 1.2 percentage points by early November 2020, the lowest yield spread since May 2018.

Substantial yield differentials impair the economic recovery in the countries hardest hit by the crises of the past 13 years and reflect a fragmented market for sovereign bonds in the euro area. This lack of a large liquid market of low-risk sovereign bonds is holding back the international role of the euro. NextGenerationEU is a first political step in the right direction, the next should be to relinquish the misguided belief that financial markets have a beneficial role to play in disciplining national policymakers.

6 Conclusion

The current ECB strategy of inflation targeting requires only minor adjustments to allow the ECB to best provide price stability and support the EU's objectives of high employment and sustainable growth. Strict rules such as monetary targeting or nominal GDP targeting may be easier to understand and monitor. However, in an environment of uncertainty, automatic rules increase the variability of inflation and output and result in welfare losses. The key to inflation targeting is a symmetric inflation target that serves as a benchmark for private-sector expectations and a central bank that transparently justifies its policy actions and is held accountable.

The ECB's mandate is not narrow but rather hierarchic. As one of only two macroeconomic policies, the remit of monetary policy includes creating the conditions for high employment and sustainable growth. Preventing or reversing labor market hysteresis must therefore factor into monetary policy decisions. Similarly, climate change needs to enter the ECB's policy considerations to ensure "that the monetary policy measures it has adopted will not work against the effectiveness of the economic policies followed by the Member States" as noted by the European Court of Justice in a different context (CJEU 2015). For example, corporate bond purchases which predominantly lower financing costs for carbon-intensive firms lower the effectiveness of policies such as the European Green Deal and run counter to the EU's commitments within the Paris Agreement. The UK government recently updated the Bank of England's monetary policy remit "to reflect the government's economic strategy for achieving strong, sustainable and balanced growth that is also environmentally sustainable and consistent with the transition to a net zero economy (HM Treasury 2021). In response, the Bank of England, who like the ECB has the primary objective of price stability, announced that it will propose an "approach to adjusting the Corporate Bond Purchase Scheme (CBPS) to account for the climate impact of the issuers of the bonds" (Bank of England 2021).

The reviewed monetary policy strategy of the ECB should reflect in broad terms the EU Treaty's stipulation that the European System of Central Banks (ESCB) should "support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union". Price stability is the primary objective of monetary policy but not the only objective.

The incomplete institutional setup of the euro area and, in particular, the risk of sovereign default handicap monetary policy, expose the euro area to substantial financial instability risk and undermine the Commission's aim of strengthening the international role of the euro. Although the ECB now has the tool to effectively counter speculative attacks, policymakers must remove sovereign default from the economic policy toolbox to increase the stability of the euro area and fully harness the benefits of the common currency.

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