

Back to Basics

An Introduction to the ECB Strategy Review



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3 November 2020

- The monetary policy **framework that served us well** for much of the last 20 years has been **struggling** to meet its aims since the financial crisis. **Why?**
 - Need to **go back to basics** and revisit each element of the monetary policy framework: aims and means of achieving them
 - Need to evaluate the implications of **new challenges**

1. The current framework
2. Policy and outcomes over the past 20 years
3. Back to basics
 - Price stability and the policy aim
 - Analysis: role of money and slack
 - Instruments
 - Monetary-fiscal interactions
 - Communication

The current framework

The current euro area framework



How monetary policy should work

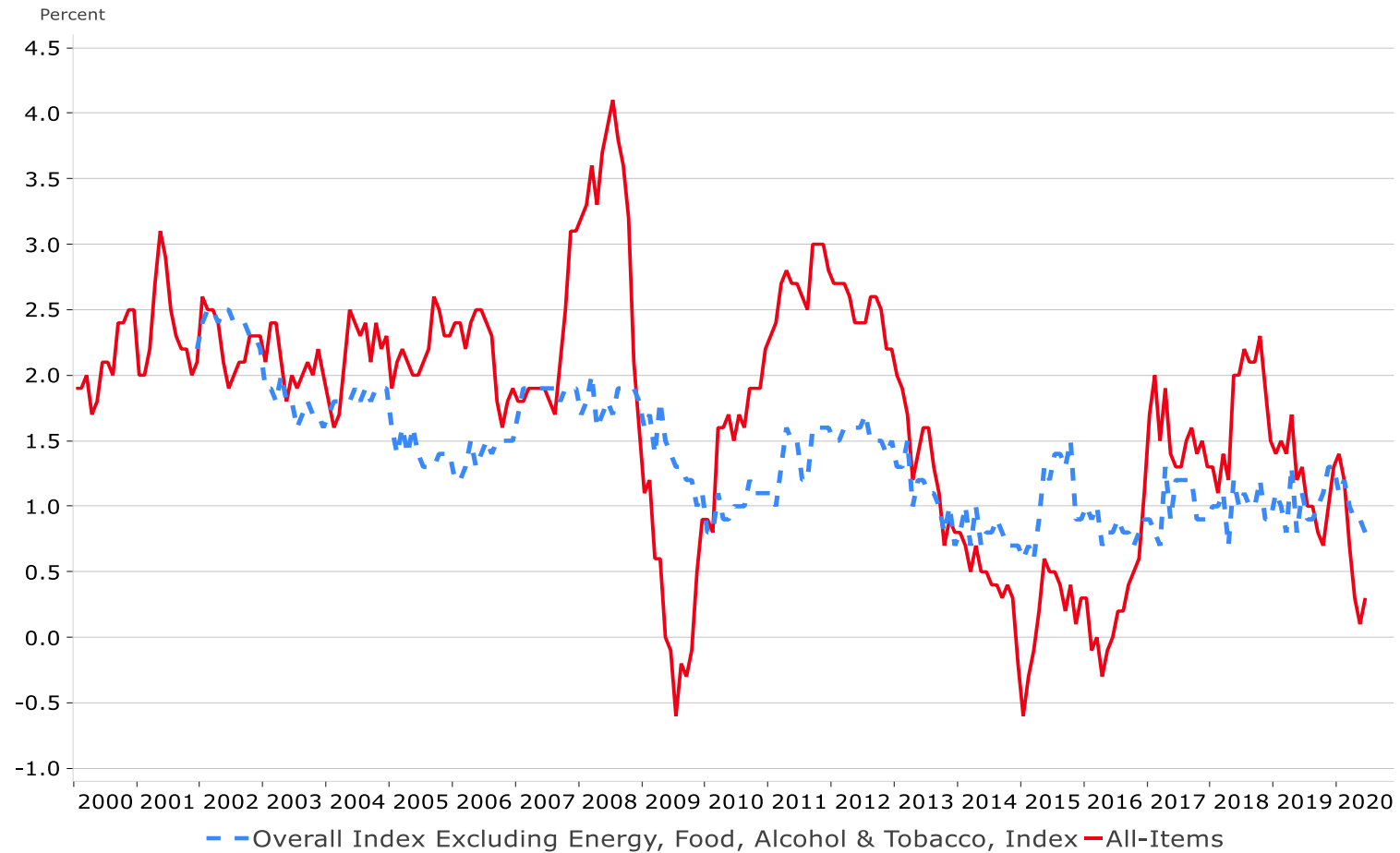


[King \(2005\)](#)

Policy and outcomes

Headline and core inflation

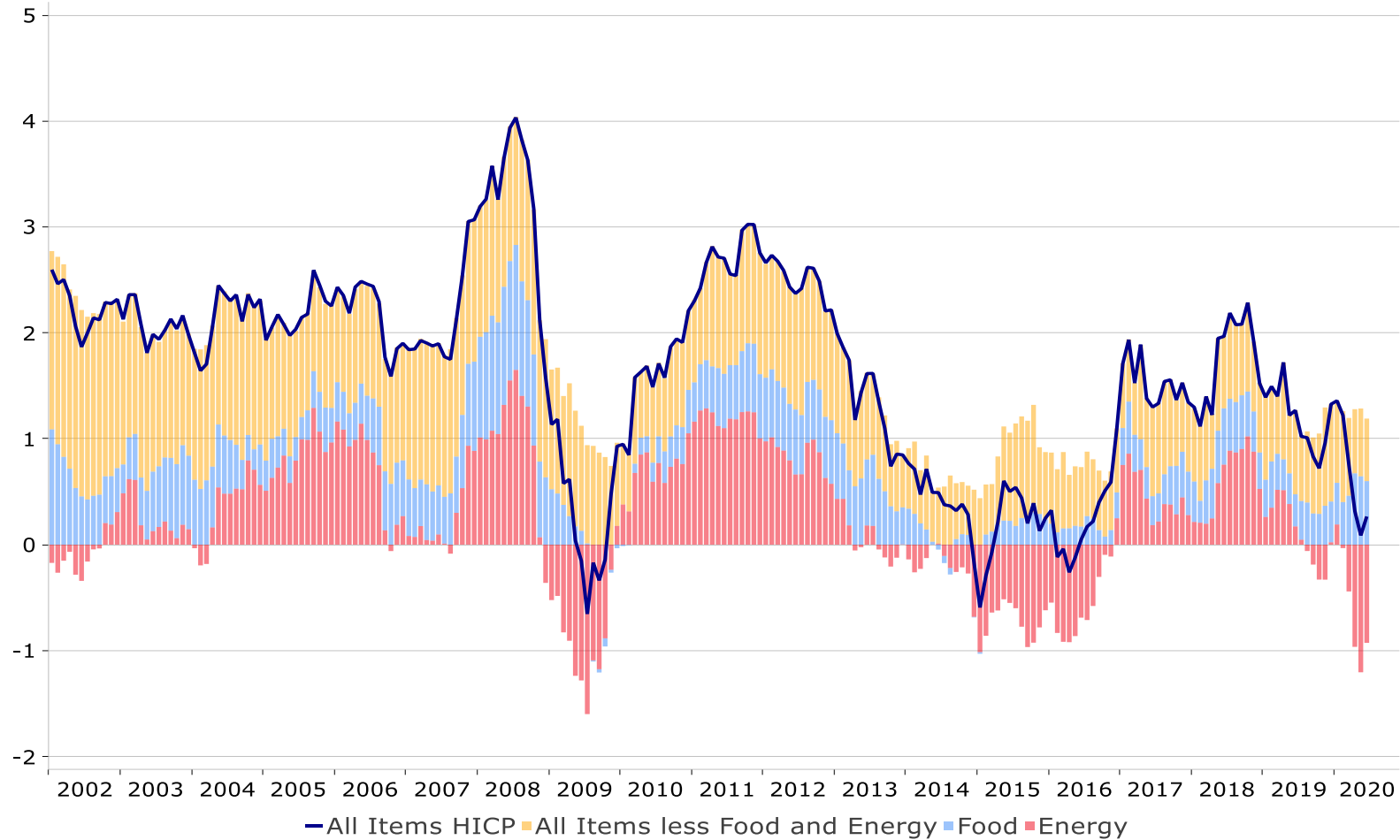
EA: HICP inflation



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Headline and core inflation

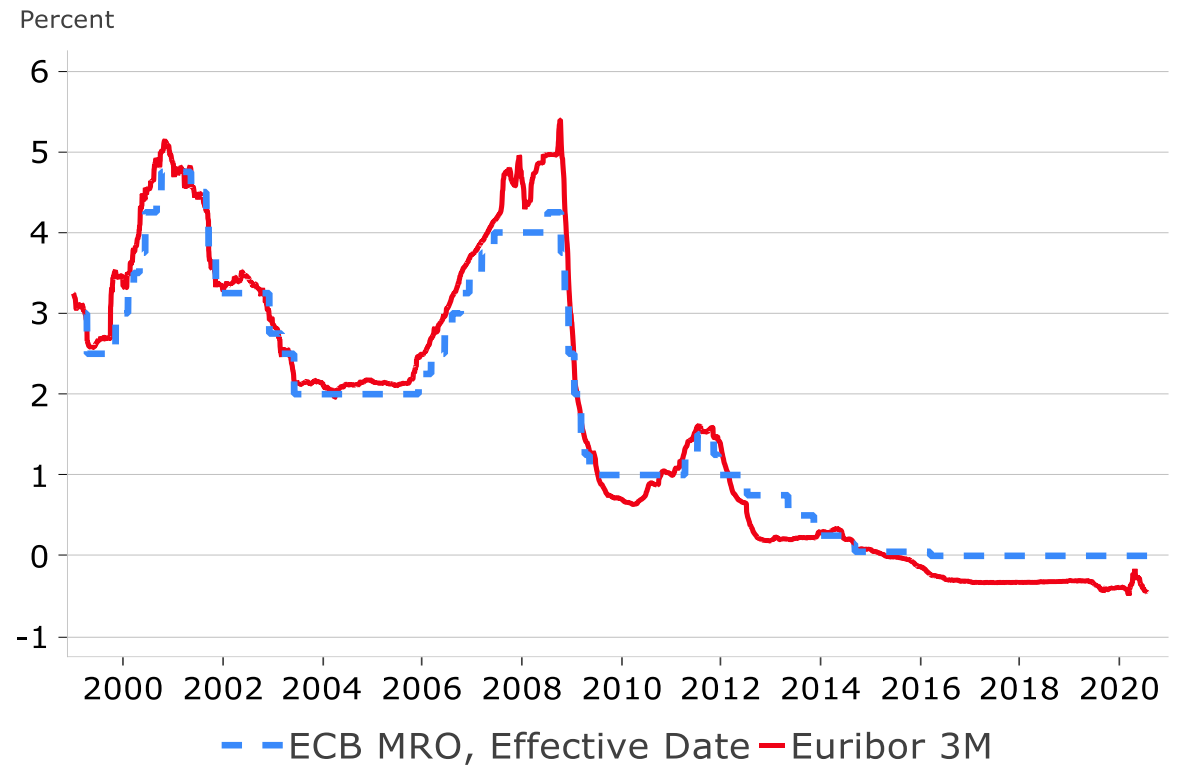
EA: HICP inflation



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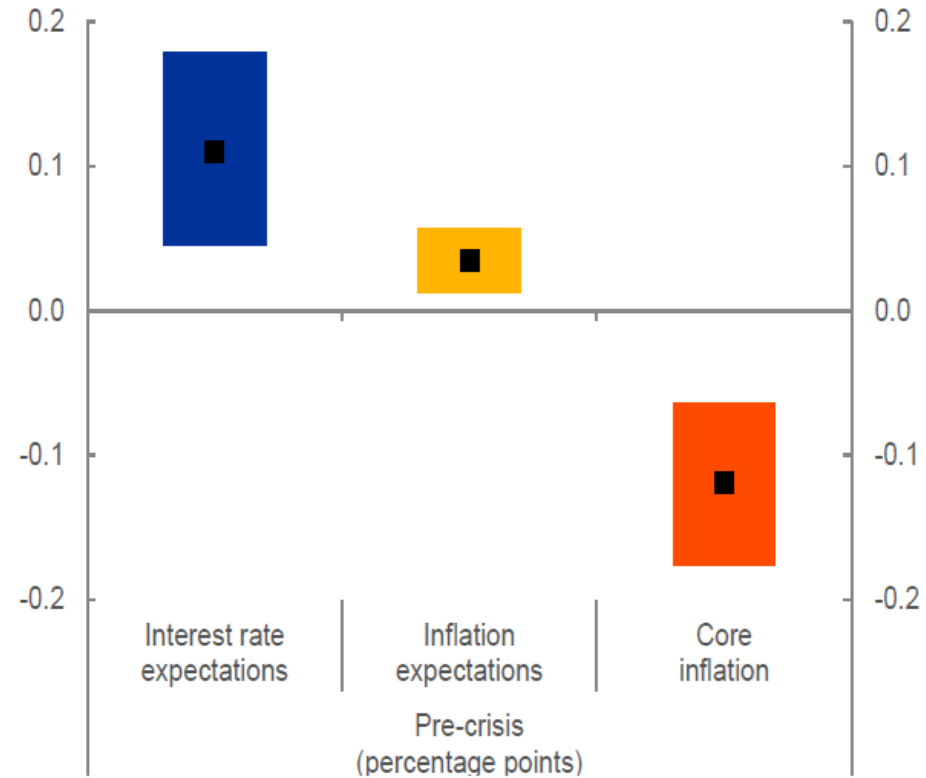
Policy rate

EA: Policy and market rates



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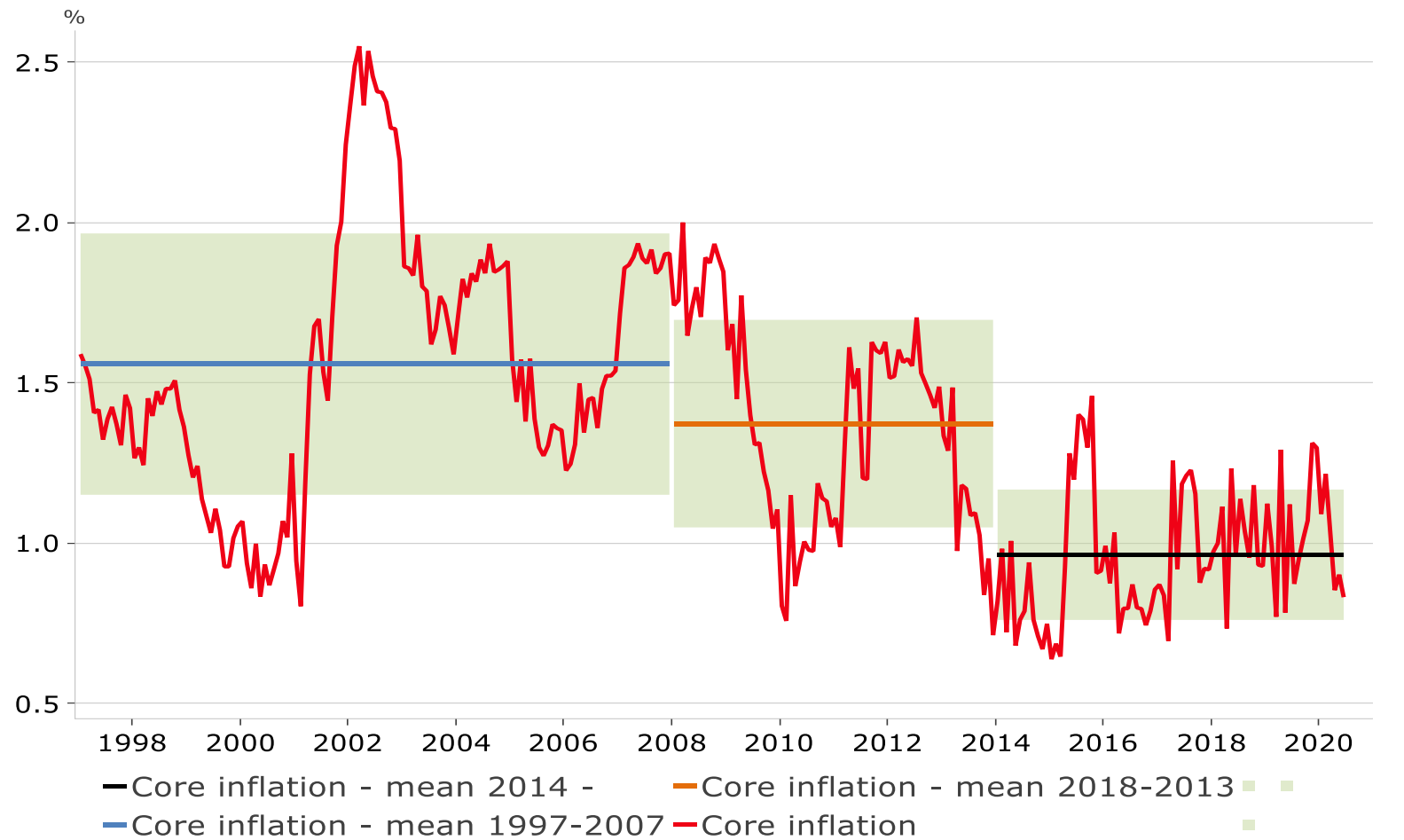
Response to oil price shocks



Source: Rostagno et al. (2019)

Core inflation

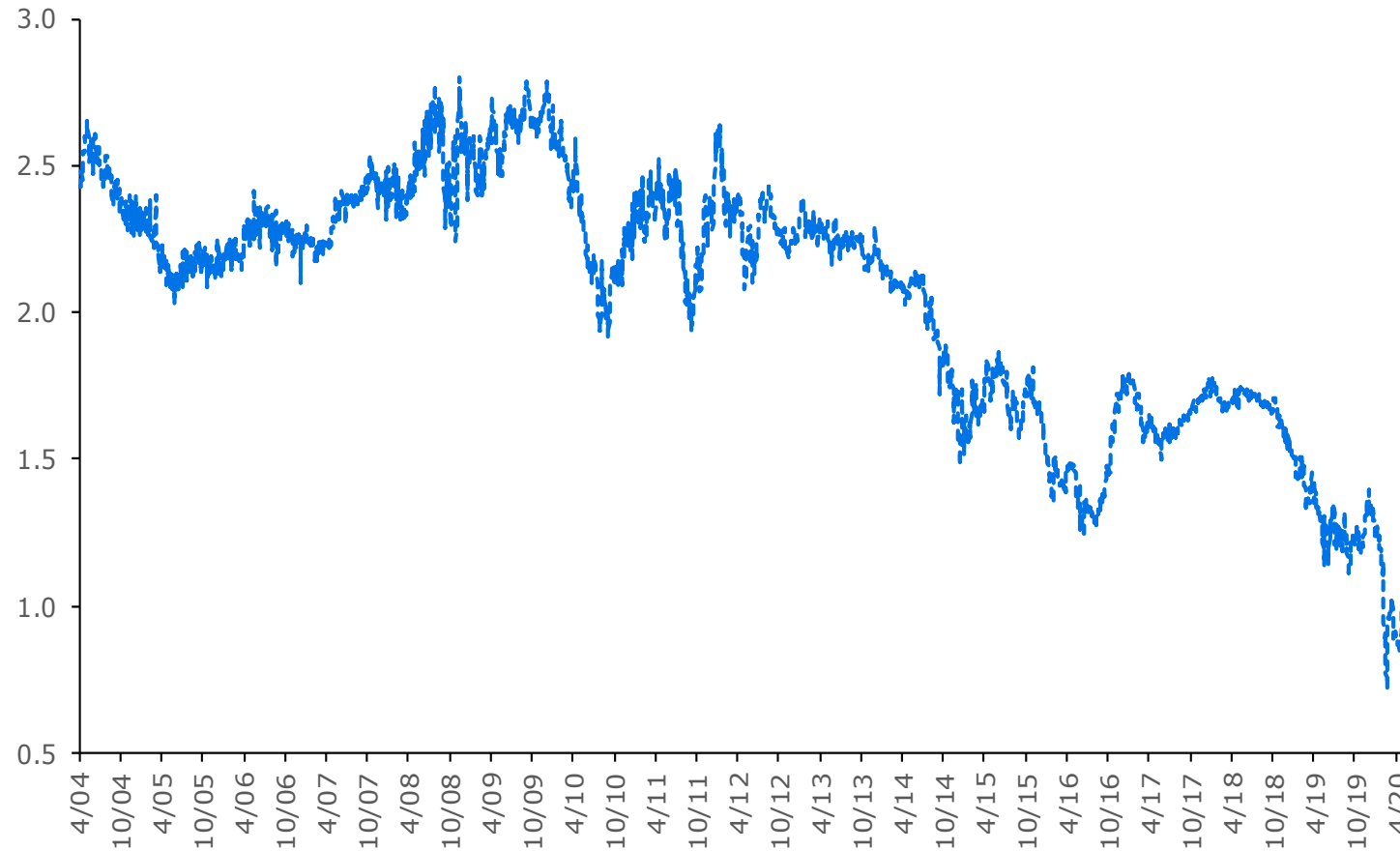
EA: Core Inflation



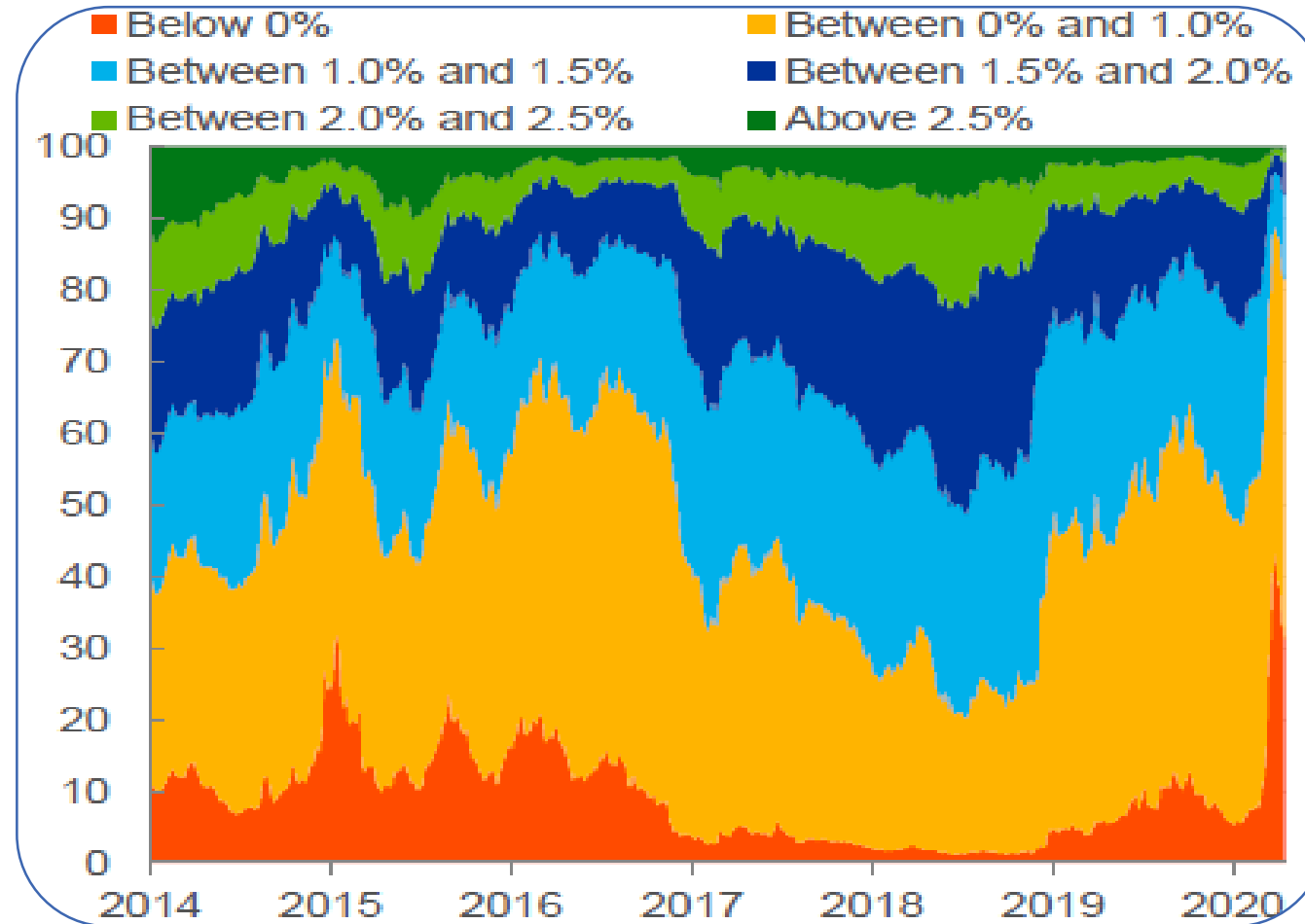
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Inflation expectations: markets

Inflation Swap Forward 5y5y (%)



Deflationary risks rising



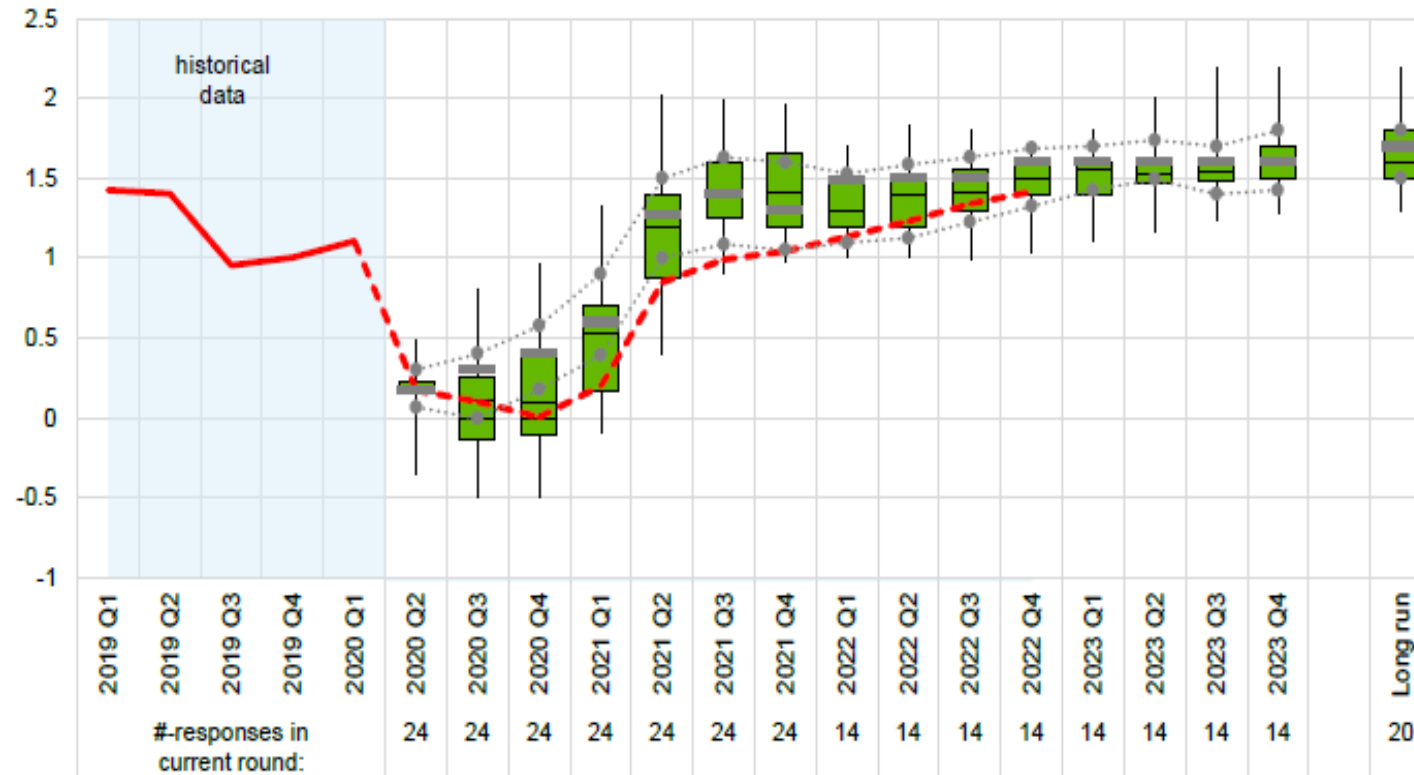
Source: ECB calculations

Inflation expectations: analysts

Cross-sectional distribution of expectations for headline inflation

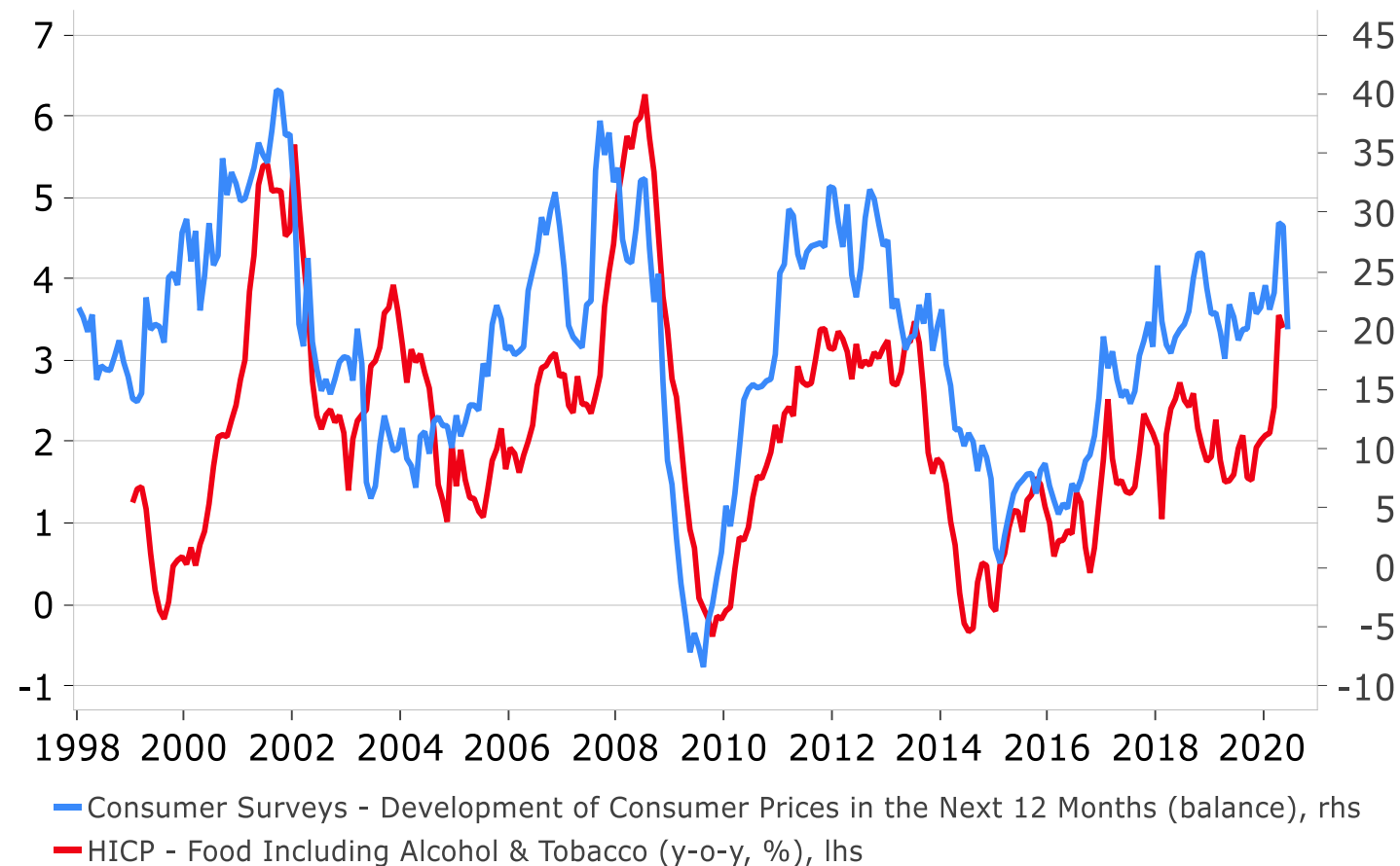
(percentage changes)

■ Current round 25th-75th percentile ● Previous round 25th-75th percentile — HICP inflation (historical)
■ Current round median — Previous round median — HICP inflation ((B)MPE projection)



Inflation expectations: households

Households inflation expectations and food prices



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- **Early success** in containing inflation in spite of adverse shock environment
- Post-GFC, core inflation and inflation expectations sliding
 - De-anchoring due to **policy asymmetry** implied by a well-understood aim?
 - Wrong (perception of a) **different policy aim**?
 - Lack of effective **instruments**?
 - Incorrect **analysis**? Has price formation changed?
 - Unhelpful **fiscal side**?
 - Other factors: digitalisation, globalisation...

Back to basics

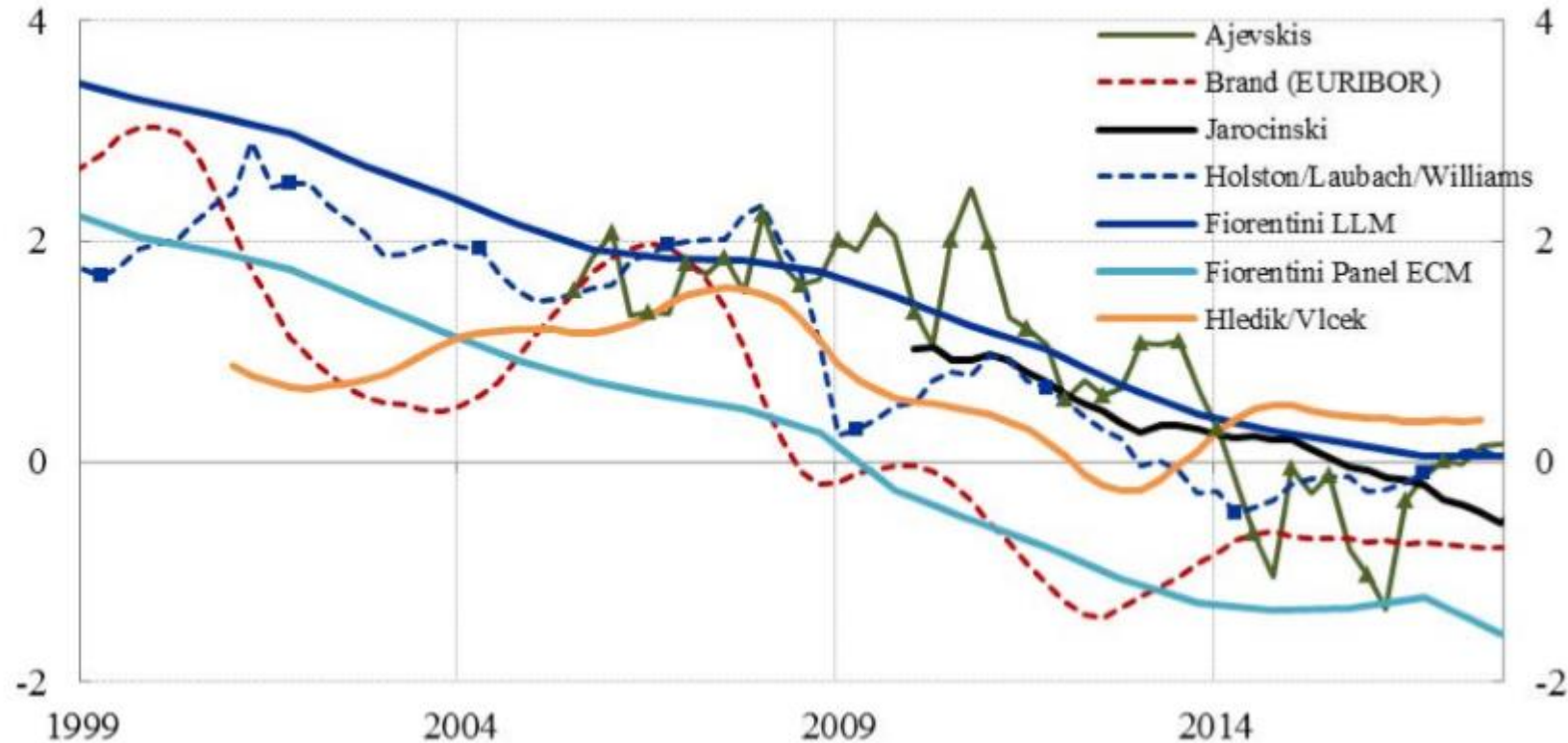


What is price stability?

- Zero inflation (HICP inflation, btw?)
 - + measurement bias
 - + downward nominal price and wage rigidity
 - + relative price adjustment across countries (incl. Balassa-Samuelson effect)
 - + safety margin relative to zero lower bound

= ?

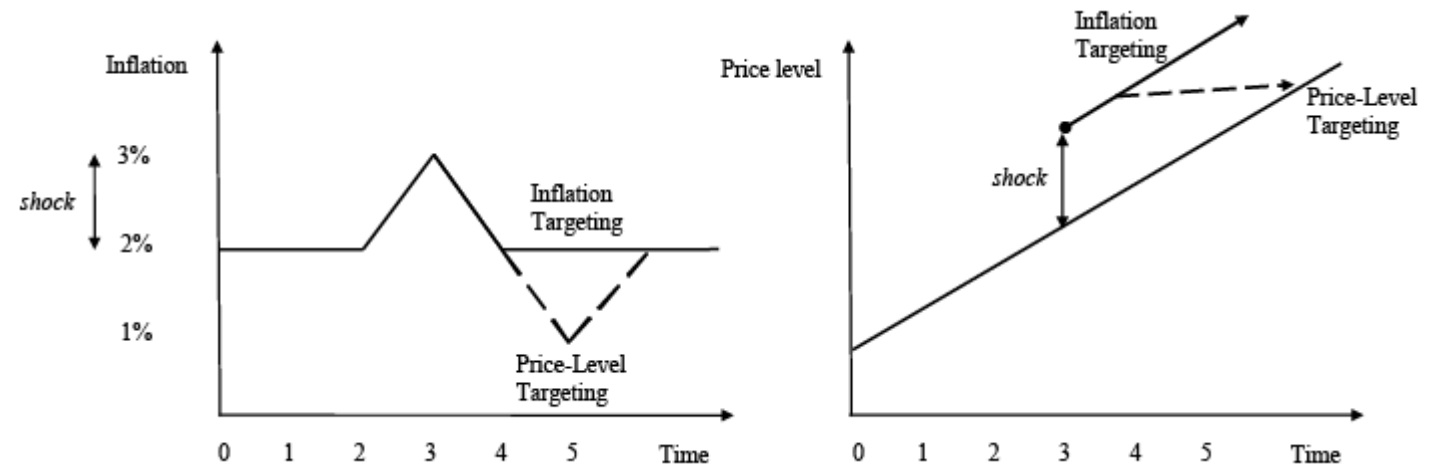
ELB considerations: the natural rate



Source: Brand et al (2018): The natural rate of interest: estimates, drivers, and challenges to monetary policy, ECB Occasional Paper

What should be the aim?

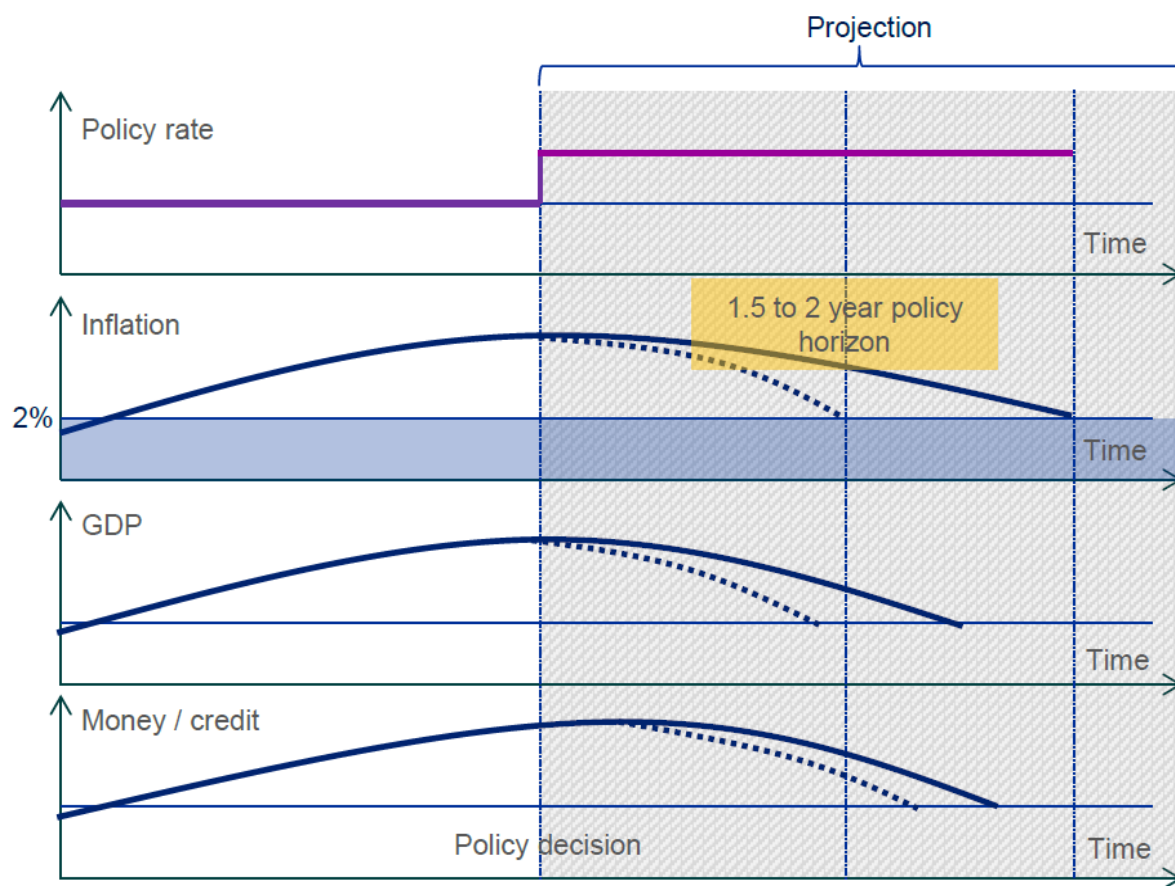
- Status quo (BBC22)?
- More symmetry?
- Some element of inertia?
 - Average inflation targeting
 - Price level targeting
 - ...



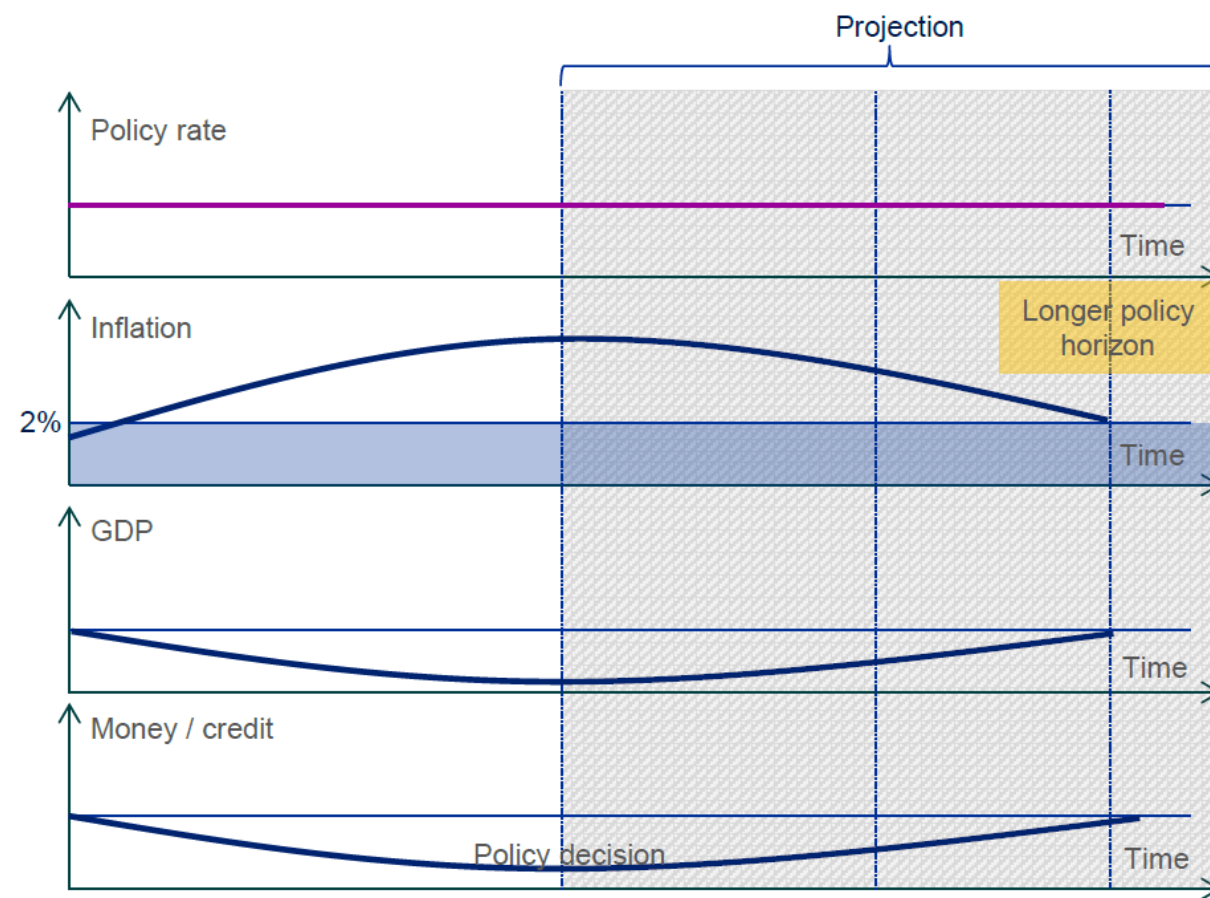
Source: Hatcher and Minford (2014)

Medium-term orientation

Demand shocks

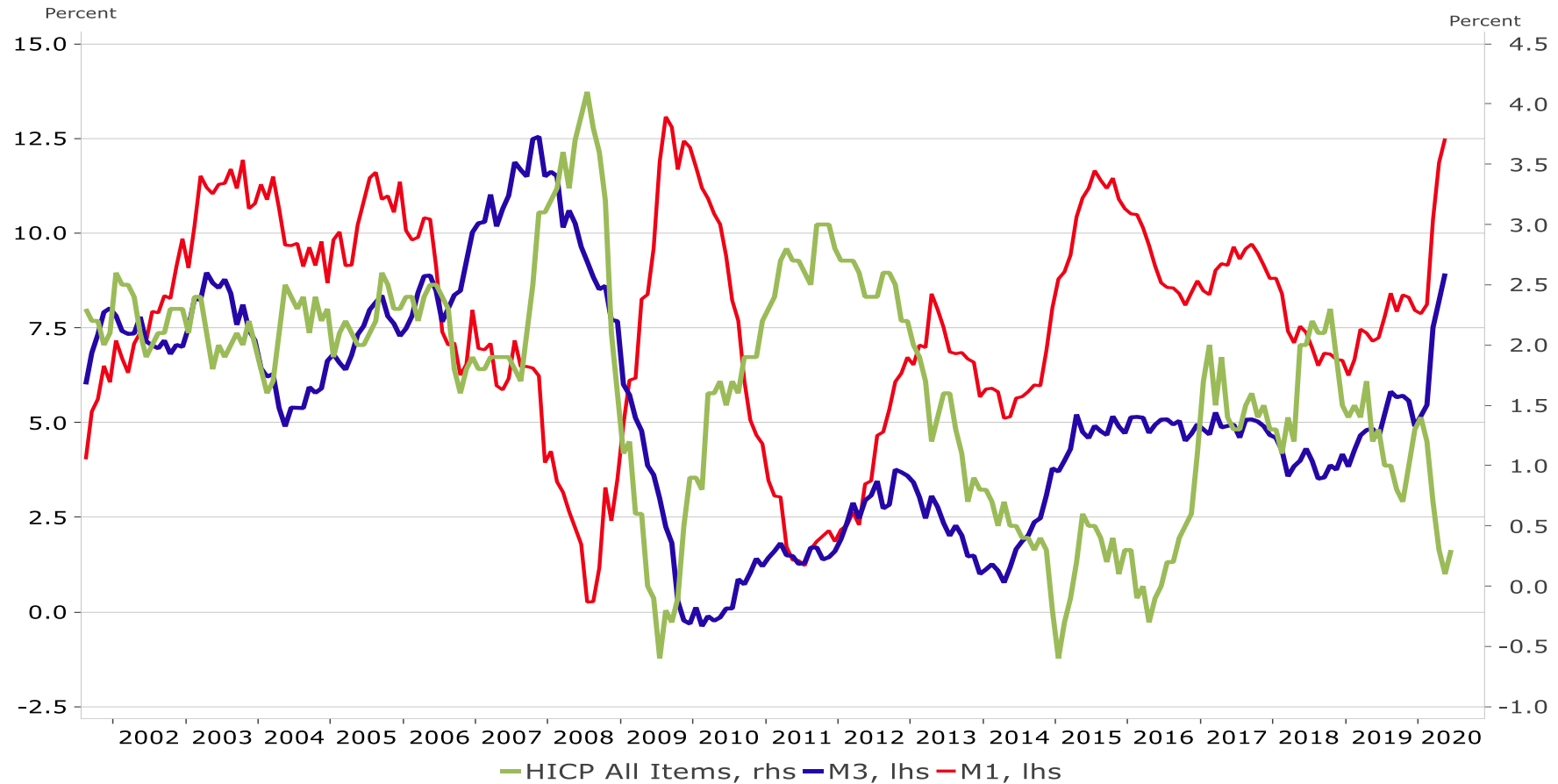


Adverse supply shocks



Analysis: “prominent role for money”

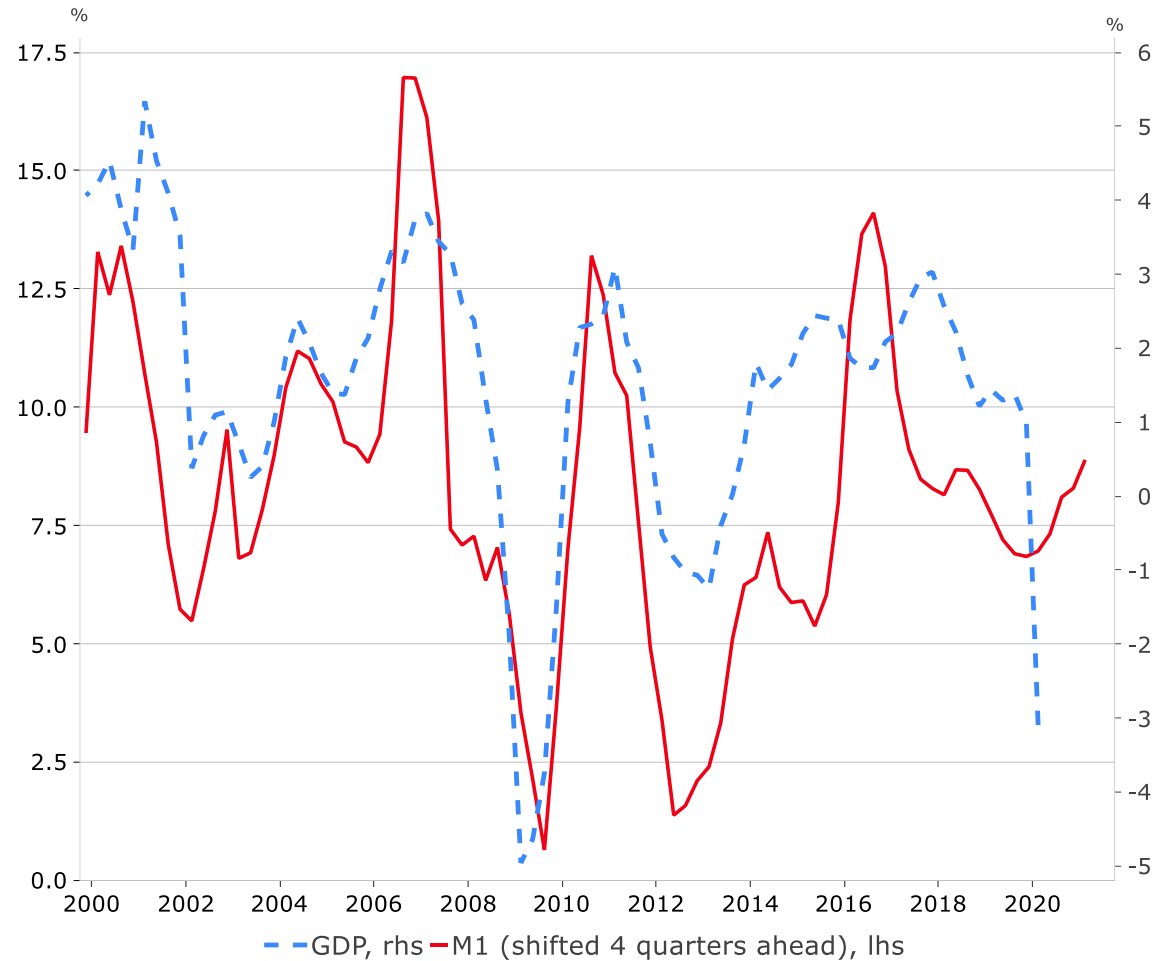
M3, M1 and HICP (y-o-y)



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Analysis: “prominent role for money”

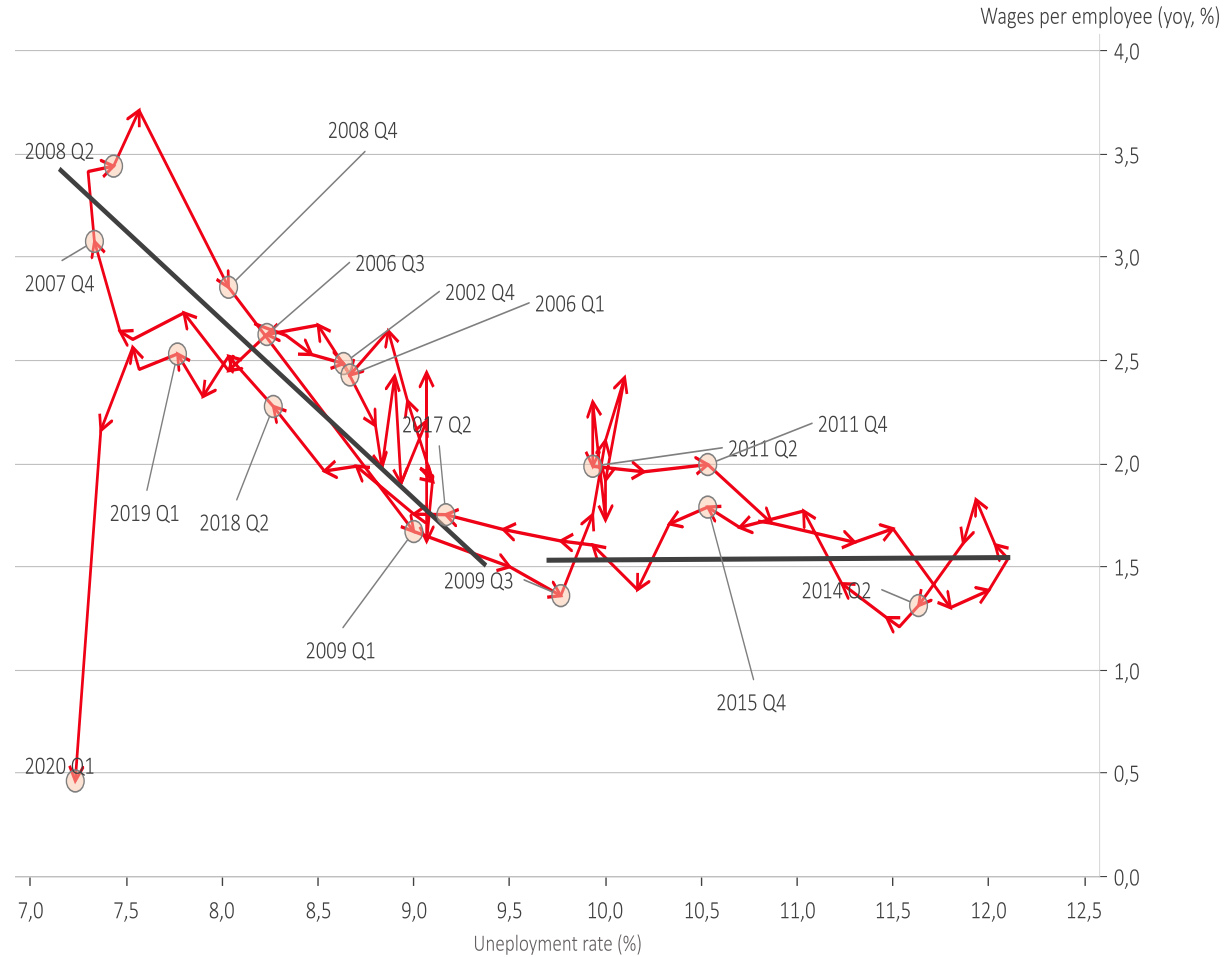
EA: Real GDP and M1 (y-o-y, %)



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Analysis: the role of slack

Rate of unemployment and wage growth



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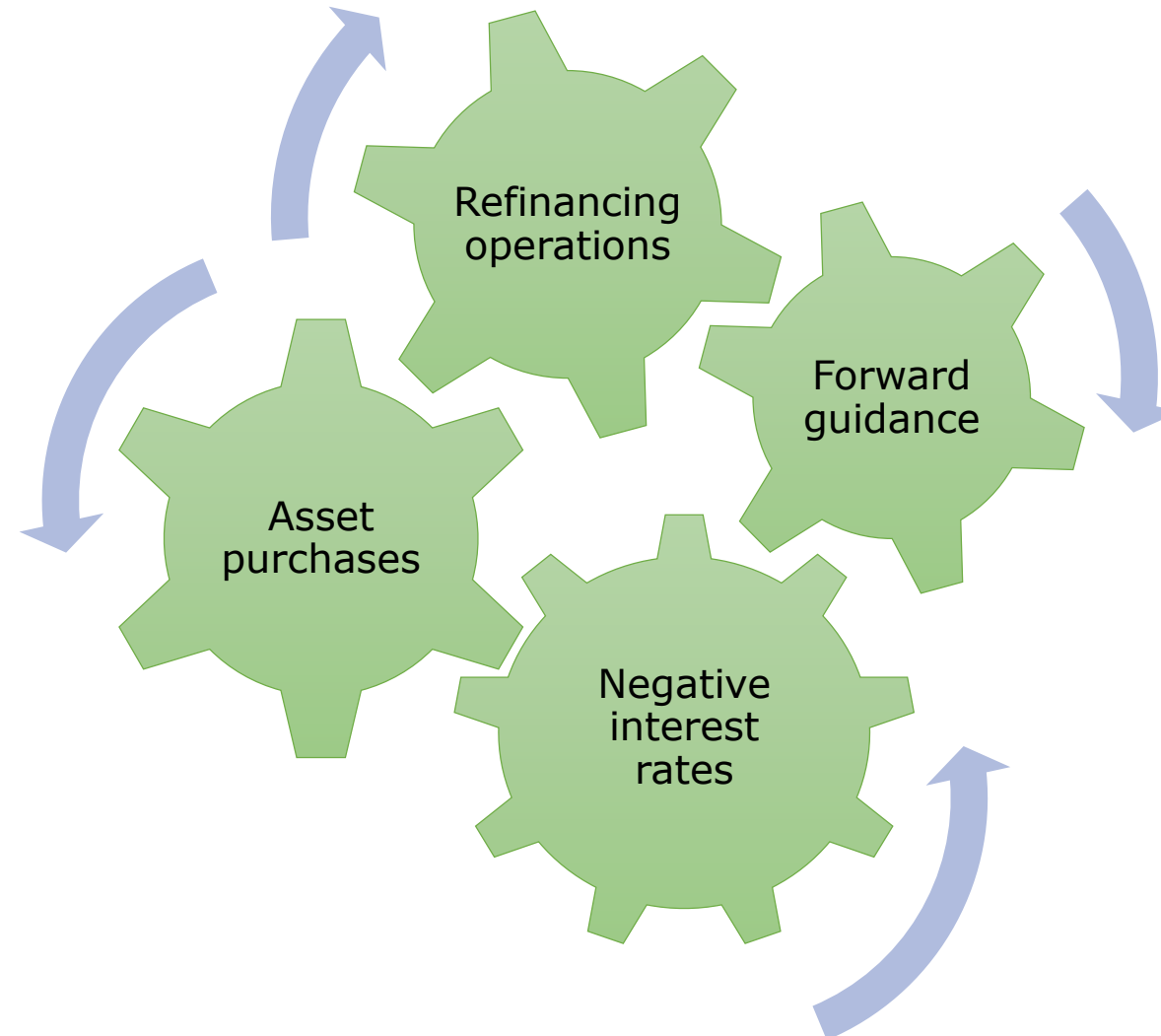
Analysis: the role of slack

Rate of unemployment and HICP core

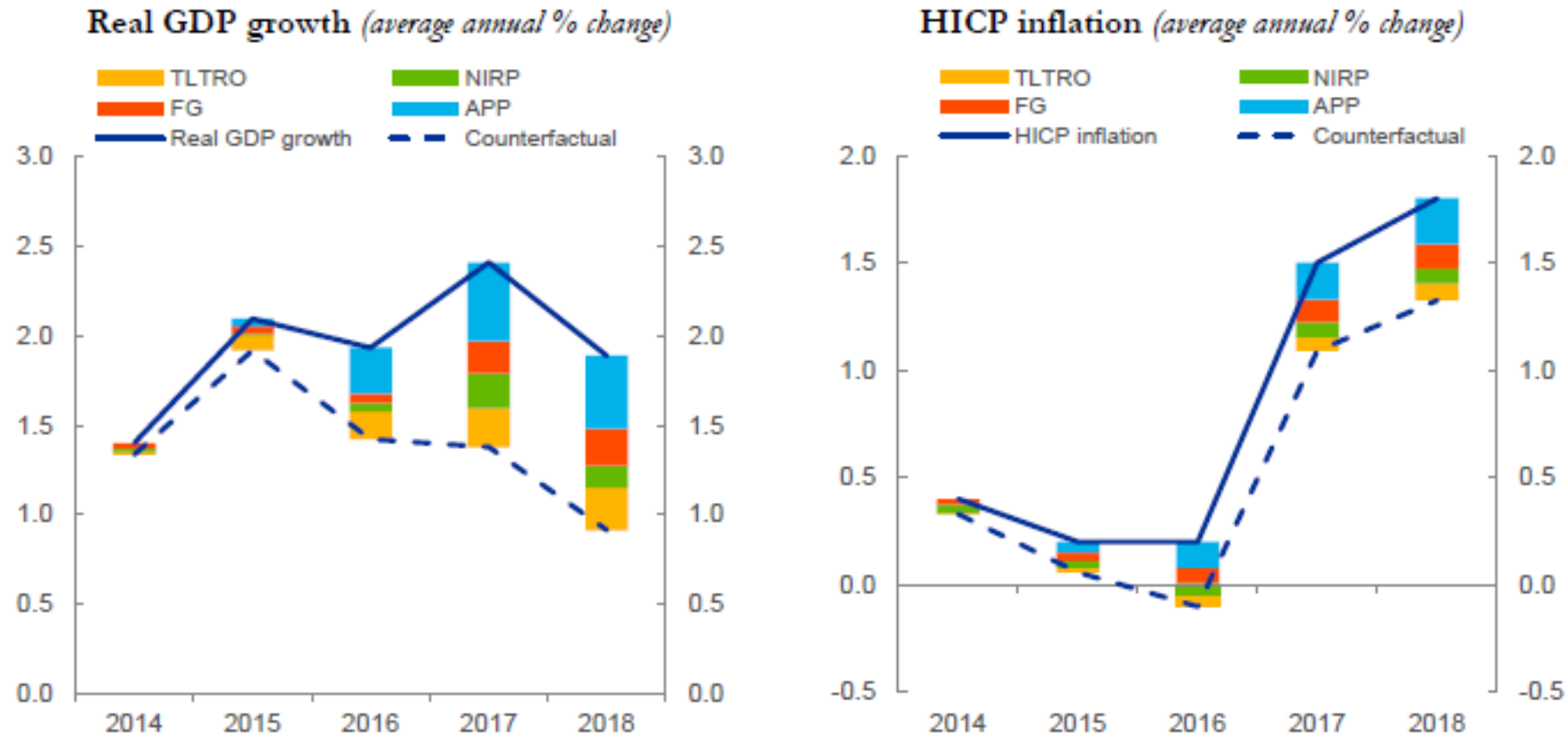


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Instruments



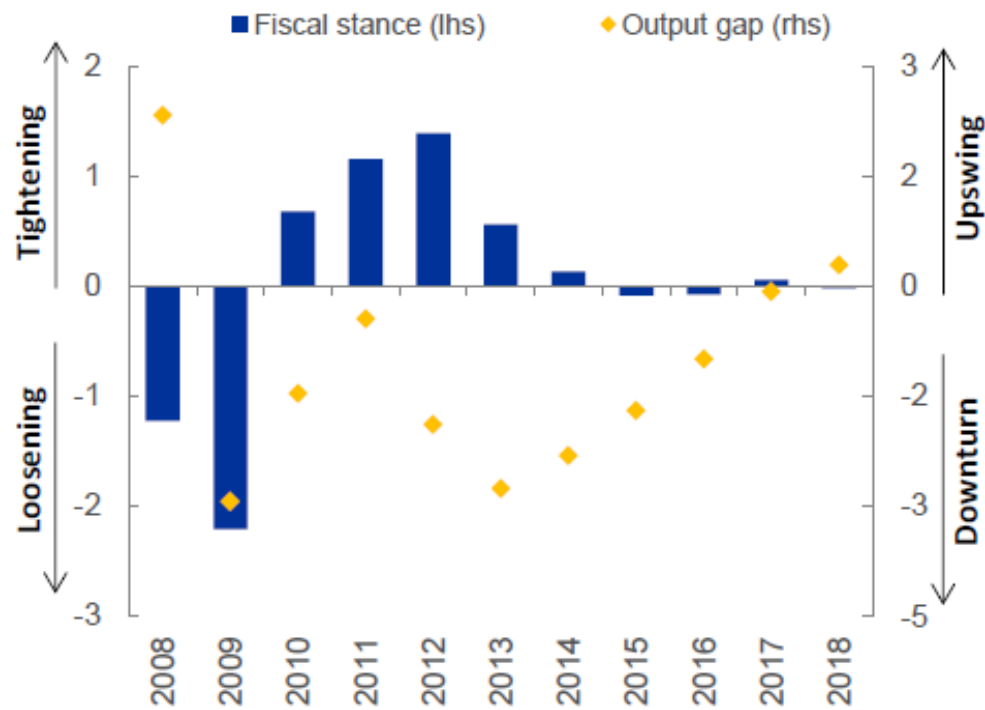
Instruments: estimated impact



Source: Rostagno et al. (2019)

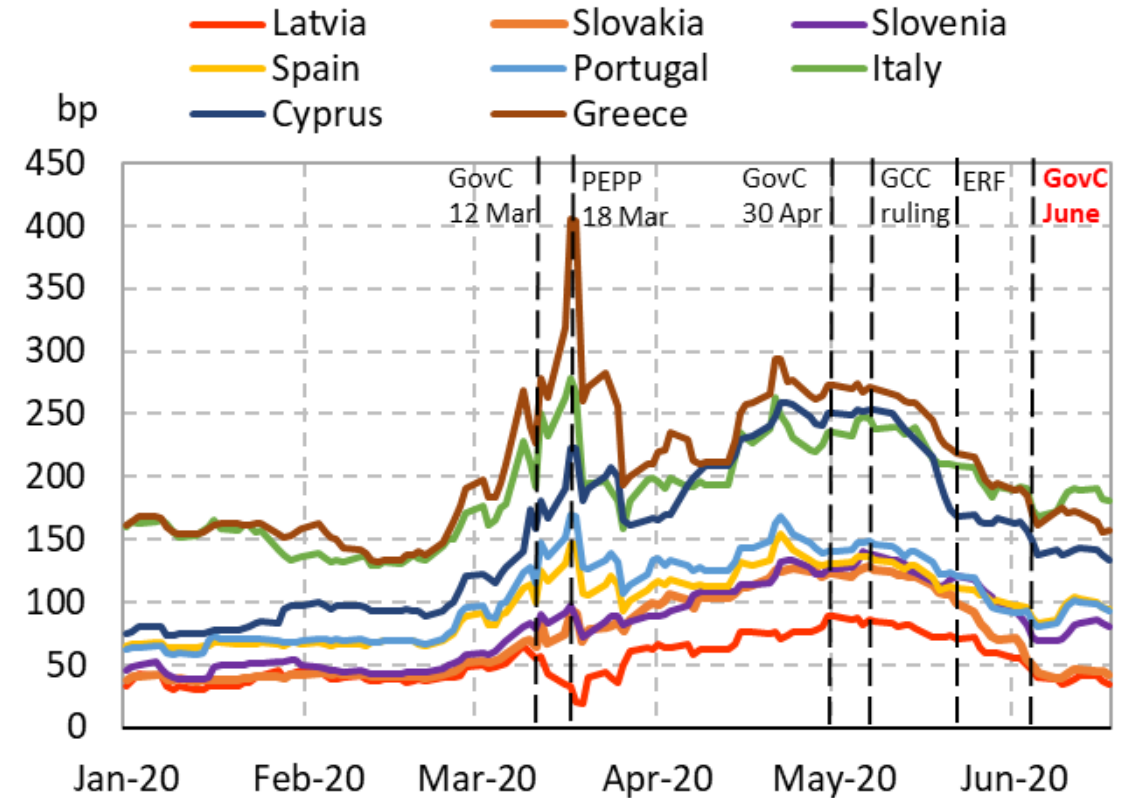
Unhelpful fiscal side?

Procyclicality



Source: Rostagno et al. (2019)

Sustainability concerns



- We are **taking a pause to reflect** on every single element of our policy strategy and its implementation
 - ✓ Price stability and the main aim within that concept
 - ✓ Medium-term orientation
 - ✓ Analysis/Modelling
 - ✓ Instruments
 - ✓ Interaction with fiscal policy
- **Other relevant aspects** I did not mention in detail today
 - The pandemic
 - Financial stability
 - Climate change

Comms: Transparency v mystery



