The ECB's mandate: maintaining price stability in the euro area

Speech at the Minda de Gunzburg Center for European Studies, Harvard University

17.10.2022 | Cambridge, Massachusetts | Joachim Nagel

1 Introduction

2 The mandate of the Eurosystem and its strategy

3 The current inflation dynamics and their drivers

4 Conclusion

---

1 Introduction

Ladies and gentlemen,

I thank you very much for the invitation to the Center for European Studies.

It's a pleasure for me to be here at Harvard University, to meet you in person and to have the opportunity to share with you my perspective on European monetary policy.

Two years ago, my predecessor Jens Weidmann gave his lecture at Harvard University online. He talked about economic policy challenges following the pandemic.

Who would have thought then that high inflation would be one of the greatest economic policy challenges, if not the greatest, two years later? On the other hand, who would have thought then that a devastating war would break out in Europe one-and-a-half years later?

During the recent meetings of the IMF (International Monetary Fund) and the World Bank Group, the G7 and the G20 (Gruppe der Zwanzig) in Washington D.C., the fight against inflation was a major topic. According to the IMF (International Monetary Fund)'s latest World Economic Outlook which was released last week, global inflation will rise from 4.7% in 2021 to 8.8% in 2022.

Most economies are currently suffering from high inflation. In the advanced economies, inflation is at a four-decade high. But let's not forget that "inflation hits the poorest hardest"[1].

Inflation has become a global problem – again. And it's up to the central banks to tackle the problem.

2 The mandate of the Eurosystem and its strategy

While not all central banks have the same mandate, most are tasked with maintaining price stability. In the case of the Eurosystem, which consists of the European Central Bank (ECB (European Central Bank)) and the national central banks of the euro area, it is indeed the primary objective.

The European Treaty establishes a clear hierarchy of objectives for the single monetary policy.[2] It gives an overriding priority to maintaining price stability in the euro area. This reflects the conviction that maintaining price stability is the best contribution monetary policy can make to sustained economic growth and employment creation.

By the way, we all know that the Federal Reserve has a dual mandate, and I wouldn't deny that this approach also has highly respected supporters. Benjamin Friedman, for example, wrote an article with the title "Why a Dual Mandate is Right for Monetary Policy." His paper concluded by saying that: "A dual mandate, explicitly addressing both inflation and output and employment, is the best way we know to achieve those ends."[3]

I do not want to delve into the single mandate versus dual mandate issue. Let me just mention that "without prejudice to the objective of price stability", the Eurosystem also has to support the general economic policies in the EU (European Union). And that includes not least the economic objectives of sustainable economic growth and full employment.

However, just as the European Treaty does not quantify the latter objectives, it does not define exactly what price stability means. Before the euro was introduced in 1999, the Governing Council of the ECB (European Central Bank) therefore decided on a quantitative definition of price stability.

According to this definition, price stability was compatible with a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2%. Price stability is to be maintained over the medium term. In 2003, the Governing Council confirmed this definition but clarified that the medium-term inflation rate should be below, but close to 2%.

One of the problems with this formulation was that it contained an asymmetry. It seemed as if upward deviations from the target were considered worse than downward deviations.[4]

As part of its strategy review in 2021, the Governing Council stated that this asymmetry might have increased the risk of a downward de-anchoring of inflation expectations. It therefore adopted a new formulation of its quantitative objective.

According to our new monetary policy strategy, we are now aiming for an inflation rate of 2% over the medium term, and this target is symmetric. It makes it clear that negative and positive deviations from the inflation target are considered equally undesirable.

In this regard, our strategy differs from the Federal Reserve's recent strategy change. Put simply, the Fed (Federal Reserve System) tolerates deviations from its target if inflation averages 2% over some time. Hence, the Fed (Federal Reserve System)'s strategy contains an element of path dependence which the Governing Council discussed as well but ultimately rejected.

3 The current inflation dynamics and their drivers

While these details kept us busy during our strategy review, they are dwarfed by the most recent developments. Inflation rates are currently alarmingly high and way above target.

In the euro area, inflation is five times higher than targeted over the medium term. In September, we recorded a year-on-year increase of 10%. Never before in the history of the single currency had headline prices gone up so drastically.

This aggregate figure masks a significant degree of heterogeneity, ranging from 6.2% in France to well over 20% in the Baltics. In Germany, inflation rates are currently somewhat above the euro area average and are likely to remain in double-digit territory over the coming months. The last time this happened in Germany was in 1951, during the Korean War.

The current wave of inflation has also been triggered by a war. The Russian aggression against Ukraine has caused a huge surge in prices, above all for energy. This has been significantly stoking price dynamics in general.

However, this is not the only reason for the high levels of inflation. Even before the outbreak of the war, price pressures had intensified considerably.

The global economy's unexpectedly swift recovery from the pandemic-induced recession was a major driver of these dynamics. The rapid revival in economic activity, supported by fiscal and monetary policy measures, pushed commodity prices up.

Another contributing factor was the shift in consumer demand away from services towards durable goods during the pandemic. This is why industrial production, in some cases, failed to keep up with demand. This further exacerbated price dynamics, both at upstream stages and for final products.

Moreover, the pandemic and also the war disrupted global supply chains and transport routes. Some of these supply disruptions have proved to be more persistent than initially thought and contributed to price increases. Finally, with demand being robust, energy prices were already on the rise before the war began.

While energy and food prices are the main drivers of the current wave of inflation in the euro area, inflation dynamics are gaining breadth. Core inflation, which strips volatile food and energy prices out of headline inflation, has risen in the euro area to 4.8% in September.

Inflation has an economic and social price tag: low-income households are typically hit harder by inflation, simply because they spend more of their current income on consumption. And, what is currently even more severe, they spend a relatively large share of their income on goods and services whose prices have risen sharply recently and which they are hardly able to replace like heating, electricity or food.

Families with children and single parents with low incomes are therefore experiencing above-average inflation rates. By contrast, high-income individuals have a below-average rate.[5] Many people are concerned that they cannot afford their cost of living once the higher energy costs become fully effective.

Price stability is, in general, a necessary condition for protecting people from real income losses. However, price stability does not protect all income groups equally as they differ in their income and consumption structures. The higher the euro area inflation rate, the larger the gaps between different income groups. As high inflation hits the poorest hardest, it may even sow the seeds of social unrest.

Still, there is very little that central banks can do about this immediate fall-out from the surge in inflation. Rather, fiscal and social policy have to address such concerns about the distributional impact of inflation. More specifically, governments are called upon to provide targeted financial relief, especially to low-income households.

Fiscal transfers to those in need are in principle superior to interventions in price formation. Price caps or consumer subsidies impair the steering function of market prices and the signal of scarcity they generate. In addition, they also benefit people who do not need support.

While targeted measures are needed, fiscal policy should currently be very careful with broad-based deficit-financed expenditure programmes. Otherwise, as long as inflation pressures remain high, there is the risk that monetary and fiscal policies are working in opposite directions. We have experienced a series of supply-side shocks, and in such a situation, a large fiscal stimulus may be harmful. The recent experience of the United States illustrates the inflationary effect of broad-based fiscal stimulus very well.

We expect to reach the peak of the current wave of inflation in the euro area soon. And in 2023, inflation rates are likely to gradually recede. That is, at least, the broad picture painted by inflation projections published by various institutions, including the Eurosystem.

Yet recent experience has taught us that forecasts have systematically underestimated the current inflation dynamics. And there is no guarantee that they will now capture them correctly, either.

One reason for these repeated forecast errors is certainly the difficulty in capturing the energy price dynamics. But they could also be the result of a transition from a low-inflation regime to a high-inflation regime. In case of such a regime switch, mean-reverting models tend to predict the return of the inflation rate to its long-run average too quickly and expert judgement becomes increasingly difficult.

Therefore, in the current situation, the baseline staff projections may be a less reliable guidepost for taking the appropriate monetary policy decisions than they used to be in the past. Hence, we should augment our baseline inflation forecasts with an extended risk assessment and have a close look at it.

In any case, monetary policymakers cannot take it for granted that inflation will return to normal levels on its own. On the contrary, we need to act decisively to prevent inflation from becoming entrenched in the euro area.

The current period of high inflation immediately follows a period of persistently low inflation for several years. Years in which the Eurosystem took unprecedented expansionary measures to stimulate inflationary dynamics. These measures included asset purchase programmes, negative interest rates, long-term refinancing operations, and forward guidance. Hence, the Eurosystem's monetary policy response to the current inflation wave has started from a very accommodative stance.

In its forward guidance, the Governing Council of the ECB (European Central Bank) announced a series of exit steps. First, net asset purchases were to be terminated. Then interest rates were increased.

While we stuck to this sequence of events, in the end we had to take steps more rapidly, and of a larger magnitude, than originally expected. In July, the Governing Council raised the key interest rates by 50 basis points and thereby ended the period of negative interest rate policy in a first step.

It was followed by another 75 basis points step in September. And it has been communicated clearly that further rate hikes are to be expected at our next policy meetings.

Nevertheless, we have refrained from commitments regarding the size of future rate hikes. Instead, we will continue to follow a meeting-by-meeting and data-dependent approach. I think this is the right approach given the extraordinary degree of uncertainty.

At the current juncture, the monetary policy stance in the euro area is still accommodative. This implies that it continues to stimulate the economy, and thus inflation. Obviously, we have to withdraw that stimulus quickly. And if this is not enough to bring the medium-term price outlook in line with the 2% target, we will have to move the policy stance into restrictive territory.

Benjamin Friedman recently said in an interview: “Whenever a central bank realises that it has to change its monetary policy, it always wishes it had acted earlier.”[6]

I would agree inasmuch as it is difficult to find the right time for a monetary policy turnaround in real time. In retrospect, it is, of course, always easier to assess a certain configuration. However, taking into account the series of exit steps before the first rate hike, I would say that the Governing Council of the ECB (European Central Bank) started acting on time.

When I took office at the start of this year, I warned against inflation risks. Today, from my point of view, it is important for the Eurosystem to proceed decisively on the path of normalisation. We must not let off until price stability has been restored. Or to say it in the words of Chairman Powell: “(W)e must keep at it until the job is done.”[7]

Of course, I can only speak with respect to the euro area. There is indeed a risk of monetary tightening being stopped too early. A premature stop could result in a more prolonged period of high inflation that will require an even tighter monetary policy later on, which could then result in an even more severe recession. Incidentally, the Fed (Federal Reserve System) learned that lesson the hard way with two consecutive recessions in the early 1980s.[8]

In a similar vein, Claudio Borio, the chief economist of the BIS (Bank of International Settlement), recently said: “Failing to act forcefully might reduce the near-term costs, but at the expense of higher ones down the road: once inflation becomes entrenched, it is all the harder to rein it in.”[9]

Nevertheless, some may argue that the Eurosystem should refrain from decisive rate hikes. In my view, we should take to heart what the ECB (European Central Bank)’s first President Wim Duisenberg once said. Confronted by calls from public officials to cut rates, he replied: “I hear, but I don’t listen.”

Compared with the Great Inflation of the 1970s, central banks nowadays have two significant advantages. And these two advantages should help them not to give in to those calls.

The first advantage is that central banks’ independence is more respected today than it was in the 1970s. Moreover, greater importance is attached to the objective of maintaining price stability. The value of independence is particularly evident in times of headwinds. And these headwinds will certainly increase when economies slump.

The second great advantage is that central banks have gained credibility in their commitment to preserving price stability. Based on a track record of low or moderate inflation, central banks have built up a reputation. Credibility and reputation pay off in terms of trust in the central bank. And trust is an asset of high value since it helps to anchor medium- to long-term inflation expectations.[10]

However, trust is not set in stone. If central bankers act half-heartedly in their fight against inflation, they risk losing their credibility and harming their reputation. Decisive monetary policy action is the only way to prevent inflation expectations from de-anchoring in the euro area.

4 Conclusion

Ladies and gentlemen,

let me conclude.

Those who thought inflation was dead now know better. Inflation wasn't dead.

Metaphorically speaking, it was just hibernating, as Claudio Borio put it.[11] Now the beast has woken up from its slumber and is more rampant than it has been for a long time. It's up to monetary policymakers to tame it again.

I am convinced that the Eurosystem has the appropriate tools to restore price stability. And I am confident that, by using them, we will fulfil our mandate and restore price stability.

Thank for your attention.

Footnotes:

1. International Monetary Fund (2022), World Economic Outlook, October, p. 5.
2. Article 127 of the Treaty on the Functioning of the European Union.
3. Friedman, B. M. (2008), Why a Dual Mandate is Right for Monetary Policy, International Finance, Vol. (Volume) 11, No. (Number) 2, pp. (pages) 153-165.
4. Deutsche Bundesbank, The Eurosystem's monetary policy strategy, Monthly Report, September 2021, p. 22.
5. Dullien, S. and S. Tober (2022), IMK Inflationsmonitor, IMK Policy Brief Nr. 133, September.
6. https://www.srf.ch/news/wirtschaft/kampf-gegen-die-teuerung-us-oekonom-analysiert-die-muehen-der-notenbanken-mit-der-inflation

[https://www.srf.ch/news/wirtschaft/kampf-gegen-die-teuerung-us-oekonom-analysiert-die-muehen-der-notenbanken-mit-der-inflation]
(own translation).

7. Powell, J. H. (2022), Monetary Policy and Price Stability, speech at the Jackson Hole Symposium, sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 26 August.
8. Mishkin, F. (2022), The Fed (Federal Reserve System) must avoid Volcker's mistake on inflation, Financial Times, 14 September.
9. Borio, C. (2022), Monetary policy: past, present and future, remarks at the Cato Institute's 40th Annual Monetary Conference, 8 September.
10. Christelis, D. et al. (2020), Trust in the central bank and inflation expectation, ECB (European Central Bank) Working Paper Series, No. (Number) 2375.
11. Borio, C. (2020), Is inflation dead or hibernating? Speech at the Barclays 24th Annual Global Inflation Conference, 5 October.