THE EUROPEAN CENTRAL BANK AND THE INFLATION TARGETING

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Introduction

The monetary policy of the European Central Bank (ECB) and all its aspects should be quite important for all ten new member countries. These countries did not adopt the euro currency, as well as they did not participate in the single monetary policy, immediately after their joining the European Union, but they will have to continue in the process of integration. It means that these countries will have to fulfill and follow all rules and procedures of monetary integration.

The announced primary objective of the European Central Bank, the achieving of price stability, is an important aspect of the monetary policy strategy since 1999. This paper focuses on the monetary policy strategy of the ECB and engages in the problems of the ECB in the context of inflation targeting.

This paper starts with the determination of the terms of the price stability and the inflation targeting. The second section focuses on the basic elements of the ECB’s monetary policy strategy and the last section discuss the problems of ECB and inflation targeting.

The Price Stability and the Inflation Targeting

The price stability has become the primary objective of many central banks during the post-war period. The interest in price stability ensues on knowledge of the unfavourable effects of inflation, which has a negative impact on economy (for example decrease of the value of incomes and savings, higher interest rates, income redistribution from creditors to debtors, creation of tax distortions and so on).

The central banks usually use several monetary policy regimes as means of achieving the price stability. The inflation targeting is one of them.

The inflation targeting was first adopted by New Zealand in 1989 and it can be defined as a policy to achieve a low inflation rate with several key features: i) a public announcement of inflation target, ii) an institutional commitment

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2 For more see Stavárek (2003) among others.
to price stability as the primary goal of monetary policy, iii) a model to make inflation forecast and iv) a high degree of transparency and accountability.3

The inflation targeting as a monetary policy framework usually starts with an announcement of an explicit quantitative target (an interval or a point target) for inflation for some time horizon to the public at large. After that the central bank must persuade the public at large, that its primacy goal is to provide an environment with stable prices. The third element above means that the central bank must work with a forward-looking operating procedure where it uses an internal conditional inflation forecast as an intermediate target variable.

The transparency and the accountability are others key features. Monetary policy is more efficient when the public at large understands policy objectives and the links between monetary policy measures and these objectives. Market participants can easily understand central bank behavior, if they know the inflation forecast (higher predicted inflation means higher interest rate).

For effective implementation of inflation targeting, the central bank must be able to conduct its monetary policy independently of political pressures. The objective of price stability must be clearly defined as a main goal of its monetary policy and the central bank shows its aim and responsibility to achieve it. There must exist a strong institutional commitment to make price stability the primary goal of the central bank.

The ECB’s Monetary Policy Strategy

When the European countries negotiated the Maastricht Treaty they determined the design of the European Central Bank (ECB) and chose the model of central banking that may be called the German model. It means that the ECB is an independent central bank and its primary objective is maintaining price stability. The ECB considers the focus on this objective as quite important for the successful long-term performance of the economy in euro area.

But it does not mean that the ECB is not able to pursue other objectives (e.g. the maintenance of high employment, sustainable non-inflationary growth and so on). The ECB is able to support the general economic policies on condition that their pursuit does not endanger price stability.

The primary objective of price stability is assigned by the Maastricht Treaty, however, the Maastricht Treaty did not assign the definition of price stability. It was formulated by the ECB in 1998, when the Governing Council of the ECB defined the price stability as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) of below 2% over the medium term and specified that price stability is maintained over the medium term. In 2003, the Governing Council clarified that, within the definition, its goal is to maintain inflation rates below but close to 2%.

3 For more details see Bialonczyková (2003).
This clarification emphasized the need for a sufficient safety margin against the risk of deflation that has the same negative impacts on economy as inflation. The HICP is a specific price index, that has been harmonized across the various countries of the euro area and that most closely approximates the changes over time in the price of a representative basket of consumer spending.4

Before the monetary union started, it was largely discussed which monetary strategy the ECB should follow. The European Monetary Institute summarized the options and on basis of that, the ECB would have to choose between two options: i) monetary targeting and ii) inflation targeting or possibly a combination of these two alternatives. A main difference between these approaches is the choice of the intermediate target (see Table 1).

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In order to best assess the risk to price stability, the ECB has finally designed a two-pillar structure of its monetary policy strategy. The first pillar is based on the idea that inflation in long-run is a monetary phenomenon, and so the Governing Council of the ECB decided to assign a prominent role to money. The ECB has announced a quantitative reference value for the growth of money stock M3 (4.5 %)5. The money growth ($\Delta M$) at level 4.5 % is based on the three following medium-term assumptions6:

i) year-on-year increases in the HICP for the euro are below (later below and close to) 2 % $\Rightarrow \Delta P$

ii) GDP growth is in the range 2 – 2.5 % per annum $\Rightarrow \Delta YR$

iii) the decline in the velocity of circulation of M3 is in the range 0.5 – 1 % $\Rightarrow \Delta V$

\[ \Delta M = \Delta YR + \Delta P - \Delta V \]

The second pillar is a broadly based assessment of the outlook for non-monetary economic and financial variables (wages, fiscal policy statistics, unit labour costs

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5 For the development of M3 growth, see Graph 1.
and financial market indicators) envisages the analysis of a wide range of other economic and financial indicators.

M3 Growth and the Reference Value in the Euro Area

Graph 1

![Graph](image)


At the presentation of the ECB’s policy strategy in October 1998, the ECB announced to implement the two pillar strategy, because the ECB understood the “deviations of current monetary growth from the reference value like the risk to price stability”. As we can see in Graph 1, M3 growth persistently exceeds its reference value (the part of the year 2001 excepted). To the contrary, the inflation rate is relatively stable and low (see Graph 2). Does really money have prominent role of the ECB’s policy strategy? How does the ECB target money growth? On the base of this (among others), we can not see the ECB’s policy strategy enough transparent.

The ECB in the Context of Inflation Targeting

Although the two-pillar monetary policy strategy of the ECB is a particular combination of the monetary targeting and the inflation targeting, the ECB does not view itself as an inflation targeting central bank.

The ECB does not view itself pursuing a direct inflation targeting strategy for several reasons: i) the forecasting inflation can not help the identification of nature of threats to price stability, ii) the ECB does not consider some aspects of the textbook inflation targeting approach optimal, iii) it is difficult to integrate the information contained in monetary aggregates into inflation forecasts.

\[\text{EUROPEAN CENTRAL BANK. The Monetary Policy of the ECB. European Central Bank, Frankfurt, 2004.}\]
that are based on conventional macroeconomic model, and iv) the ECB assumes the relying on a single forecast to be unwise, given the considerable uncertainty relating to the structure of the euro area economy.

Bofinger (1999) considers the inflation targeting to be a part of the ECB’s strategy. Svensson (1999) interprets the ECB’s monetary policy strategy as a flexible inflation targeting. According to the ECB, the inflation targeting is not the part, it is the alternative strategy to its two-pillar monetary policy strategy. However, the development of the money growth (Graph 1) and inflation rate (Graph 2) show the ECB to be more the inflation targeting central bank than the money targeting bank.

Inflation Rate in the Euro Area

Graph 2


Another question could be about the „inflation target“. As we have noted above, the ECB assigned the goal of price stability, but there was great freedom in translating this into an operational goal. The target of price stability below 2 % was not so clear, as well as the specification of „the medium term“. When HICP was determined as a value below 2 %, it could be interpreted as a target range for inflation of 0 – 2 %, or as a point inflation target of 1 % with a tolerance interval of ± 1 percentage point.

8 And still is not very clear to understand, what it is “close to 2 %”.
And as we can see from the Graph 2, the inflation rate in the euro area has been almost permanently higher than the two percent objective\(^9\). In 2003, the HICP was below the level 2\%, but not only in euro area, but in Estonia too.

![Graph 3: Inflation Rate in Estonia and the Euro Area](source)


Nowadays, a lot of economists argue that the second pillar of the ECB’s strategy is redundant (Bean 1999, Eijffinger, 2003, Svensson, 2000). They suggest to conduct flexible inflation targeting – a broad assessment of all relevant information variables regarding expected inflation, including broad and narrow money growth, is incorporated in a flexible inflation targeting strategy. Generally, the abolishment of the first pillar would avoid confusion and increase transparency.

**Conclusion**

Despite the ECB does not view itself as an inflation targeting central bank, there exist some points of view, which do not agree with that. Maybe, there is the reason, why some economists call for higher transparency. It could be accomplished by leaving the first pillar (money growth persistently exceeds its reference value) and implementing the flexible inflation targeting strategy.

\(^9\) Inflation came below the 2\% reference value only in the second calendar quarter 2003
It is true that the ECB has announced the explicit definition of price stability, but we can miss the floor ceiling (we know only definition “close to 2 %”), as well as the understanding the ECB's interest rate decisions that could seem to ignore the money growth indicator (Graph 1).

References


Zusammenfassung

DIE EUROPÄISCHE ZENTRALBANK UND DIE INFLATIONSSTEUERUNG

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Mit der Aufnahme des Vertrags von Maastricht wurde es von der Zukunftsform der Europäischen Zentralbank entschieden, als die Applikation des deutschen Models des Zentralbankwesens angenommen wurde. Die Europäische Zentralbank wurde damit unter anderem vorausbestimmt, eine hoch unabhängige Bank zu werden, deren primäres Ziel die Sorge für die Preisstabilität ist, mit der Möglichkeit auch andere Ziele zu folgen (z.B. die Erhaltung der hohen Beschäftigung, Finanzstabilität usw.).


In dem ersten Teil des Beitrags sind die Gründe für die Betrachtung der Preisstabilität wie das primäre Ziel der Währungspolitik beschränkt, sowie Grundelemente eines relativ neuen politischen Systems – das Zielen der Inflation. Der zweite Teil beschäftigt sich mit der Strategie der Währungspolitik der Europäischen Zentralbank.