# The ECB needs a new mandate


BERLIN – The European Central Bank's (ECB) decision in September to pursue more monetary-policy easing was controversial, with one board representative, from Germany, resigning over the move. But one of the most remarkable features of the ECB's position has not gotten enough attention: the admission that inflation expectations have become de-anchored, and that without fiscal-policy support, the central bank will probably fail to fulfill its price-stability mandate for the foreseeable future.

In fact, many observers, and even several members of the ECB's governing council, now argue that the bank needs to adapt its mandate with a new definition of price stability in mind. They are right, but there is one crucial caveat.

Since central-bank independence was strengthened in the 1990s, it has become clear that, in normal times, the specific mandate does not matter much. The United States Federal Reserve managed to guide expectations and achieve price stability with its dual mandate, price stability and maximum employment, just as well as the Bank of England or the ECB, with their narrower price-stability mandates.

After the global financial crisis, however, the traditional mandate proved inadequate to cope with large-scale financial instability, fickle market confidence and political paralysis. Developed-country central banks had to devise policies on the fly, without a guiding framework. Each in its own way pursued unprecedented monetary easing, massively expanding its balance sheet, in order to provide much-needed support to the economy.

In many ways, these measures succeeded: Monetary expansion played a major role in pulling the economy back from the brink. But, over time, central banks’ capacity to affect the real economy declined. Today, and for the foreseeable future, domestic inflation is increasingly affected by global, rather than local, developments, and financial (in)stability and fiscal policy are far more influential than monetary policy.

For the ECB, this generates a particularly serious challenge. After all, unlike other central banks, it must account for the preferences of 19 sovereign national governments, with little to no structural or fiscal-policy coordination. The eurozone is also highly fragmented financially, lacking a common capital market, a unifying safe asset or macroeconomic stabilisation tools.

The ECB needs a more realistic and flexible mandate. Given the eurozone’s fragmented nature, that mandate should probably still be centered on price stability. But it should also recognise that the current definition of price stability, “below, but close to, 2 per cent inflation over the medium term”, is too narrow.

A broader definition is needed, according to which the ECB pursues a symmetric inflation target of 2 per cent, within a 1.5-2.5 per cent band, over a longer time horizon. Some advocate an even higher target: For example, Olivier Blanchard, a former International Monetary Fund chief economist, has proposed re-anchoring expectations at 4 per cent. A different proposal, from New York Federal Reserve President John Williams, is to target a price level, rather than an inflation rate.

A commitment to more broadly defined price stability in the long term would give the ECB more space during times of crisis, thereby enabling it to account better for risks to financial stability and the real economy. This would help it to stabilise prices more quickly, bolstering its credibility.

By contrast, when the ECB consistently fails to meet its price-stability objective, as it has for the last five years, it loses credibility. And, indeed, the ECB has faced harsh criticism, sometimes warranted, often not, over its implementation of untested expansionary monetary policies since 2008, partly because the measures were often poorly understood by the public. The loss of credibility has undermined the ECB's capacity to fulfill its objectives, creating a vicious circle that threatens its de facto independence.

This is why the timing of any mandate change must be chosen very carefully. If the ECB tries to move the goalpost while it is missing the shot, the short-term blow to its already diminished credibility could be serious. Given this, the ECB must work to strengthen its standing before it adjusts its mandate, including by attempting to reach the existing price-stability objective after years of failure.

At the same time, the ECB must communicate better what its capabilities are. Some have urged the ECB to try addressing the solvency problems of banks or governments during the crisis. Others would like the ECB to discipline governments to do the "right" thing and consolidate spending. A central bank must do neither and would utterly fail if it tried. But these attempts have hurt the ECB's standing, particularly in Germany, and have diminished its credibility.

Clarifying the contents of the ECB’s policy toolbox, including sovereign-bond purchases and other non-standard measures, would go a long way toward protecting the ECB from such attacks in the future. And when the time comes to shift its objectives, the ECB must communicate the change, which, to be sure, may not need to be as big as many believe, clearly and thoroughly.

US President John F. Kennedy was right: the time to repair the roof is when the sun is shining. The ECB cannot revise its mandate until the current storm has passed. But, with water pouring in, it cannot afford to wait very long. The sooner the ECB does what is needed to restore its credibility, the sooner it can do what is needed to protect itself from future storms.

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