

# The ECB Needs to Explain Itself



Ambiguity is hampering effective policymaking by the European Central Bank and leaving market participants wondering what to expect. A review of the ECB's policy framework would help to eliminate such ambiguity – and place the Bank on much sounder footing for a new era of leadership.

ZURICH – Finland's central bank governor, Olli Rehn, has reiterated his call for the European Central Bank to conduct a long-overdue review of its policy framework. The upcoming change of leadership at the institution – with Christine Lagarde, the International Monetary Fund's managing director since 2011, likely to succeed Mario Draghi as president – offers an important opportunity to heed that call.

When the ECB was established 20 years ago, central banks were generally not too clear about the details of their policy frameworks. At that time, some ambiguity may have been helpful, because of the flexibility it offered when the ECB started operating. Furthermore, it allowed central bankers with different experiences and perspectives to agree on a framework, even though they may not have agreed on its precise details.

But the world has changed considerably since then, and the public is now demanding far more clarity. How can the ECB offer that, 16 years after the last review of its monetary-policy framework?

Since that review, conducted in 2003, the global financial crisis, and the ensuing European debt crisis, prompted the ECB to adopt a plethora of new policy instruments. These crisis measures – which have been deeply unpopular, particularly in Germany – can be justified only to the extent that they have been effective, and this must be evaluated. Moreover, as Rehn, who sits on the ECB's governing council, has noted, long-run structural trends – such as population aging, lower long-term interest rates, and climate change – must be considered.

The effectiveness of ECB policy requires the members of the governing council to be singing from the same song sheet. They need a shared understanding of Europe's long-term goals and the strengths and weaknesses of various policy instruments. And, in order to strengthen accountability and support smart decision-making, they need to be able to spell out the details of their monetary-policy strategies in ways that the public can understand.

As it stands, such clarity is at times hard to find, even when it comes to some of the most fundamental elements of the ECB's policy strategy. Price stability – the ECB's primary objective – is currently expressed as “inflation below, but close to, 2%.” Does 1% inflation meet that condition, or is it too low, demanding more monetary-policy accommodation? Different members of the ECB's governing council may well have different answers to this question, and thus support different policies.

The same goes for the questions of whether the ECB's inflation target is symmetric – with the authorities intervening as vigorously when inflation is too low as they do when inflation is too high – and whether inflation should be measured over time or at a given moment. If, over some period, the inflation

rate ranges from 0% to 4%, but averages to “below, but close to, 2%,” has the objective been achieved?

The answer has major policy implications. If inflation is measured over time, the ECB could accept, or perhaps even aim for, a somewhat higher inflation rate in the medium term, to compensate for the excessively low inflation of recent years. If the public came to believe that a period of above-target inflation was likely, the expected real interest rate would fall, giving a jolt to the economy.

Of course, Draghi has established in speeches and press conferences that, in his view, the inflation target is symmetric; 1% inflation is too low; and the inflation rate should be measured over the “medium term.” But it is not clear whether this view is broadly shared within the ECB’s governing council.

Inflation targeting is hardly the only area where ambiguity is hampering effective policymaking and leaving market participants wondering what to expect. The ECB’s outright monetary transactions (OMT) scheme – whereby the ECB promises to purchase bonds issued by eurozone member states on secondary sovereign-bond markets – is also generating significant uncertainty.

OMT, Draghi’s chosen tool for fulfilling his 2012 vow to do “whatever it takes to preserve the euro,” was controversial from the moment it was announced, with Bundesbank President Jens Weidmann – one of Lagarde’s main rivals for the ECB presidency – arguing fiercely against it in public. But that was seven years ago, and OMT has never actually been used. Is the governing council still committed to it? Or have the events – and council membership changes – of the last few years rendered that commitment obsolete?

With public debt in Greece and Italy still far too high, the eurozone still at risk of slipping into a recession that would

significantly worsen both countries' fiscal positions, and Italian politics as volatile as ever, it would pay to know. A review of the kind Rehn demands would provide the needed answers – and put the ECB on much sounder footing for a new era of leadership.



STEFAN GERLACH

Writing for PS since **2016** Stefan Gerlach is Chief Economist at EFG Bank in Zurich and a former deputy governor of the Central Bank of Ireland. He is also a former Executive Director and Chief Economist of the Hong Kong Monetary Authority and Secretary to the Committee on the Global Financial System at the BIS.