PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Thoughts for the ECB policy framework review, 2025

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Major features of the 2021 review

- “The Governing Council considers that price stability is best maintained by aiming for two per cent inflation over the medium term. *The Governing Council’s commitment to this target is symmetric.* Symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable.

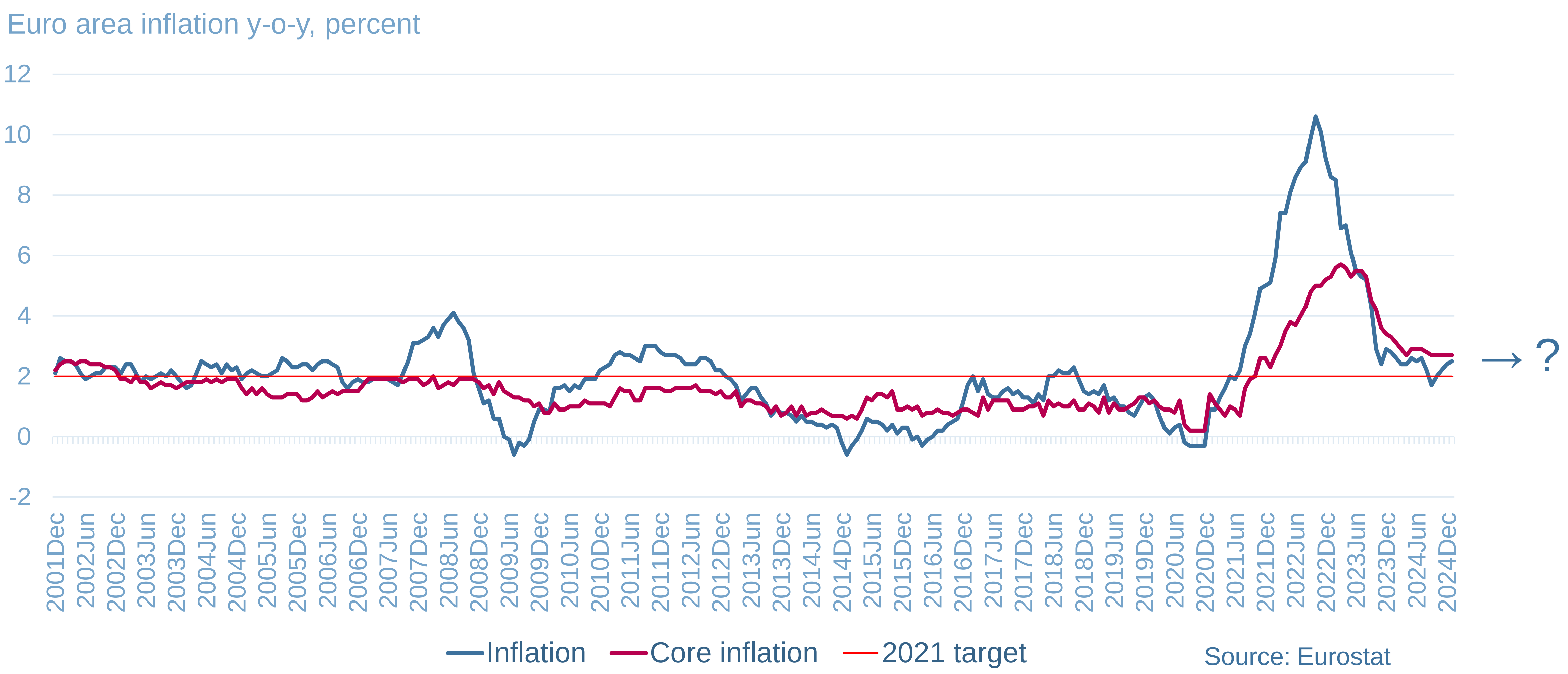
- “To maintain the symmetry of its inflation target, the Governing Council recognises the importance of taking into account *the implications of the effective lower bound*. In particular, when the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target

- “The Governing Council confirms the medium-term orientation of its monetary policy strategy.

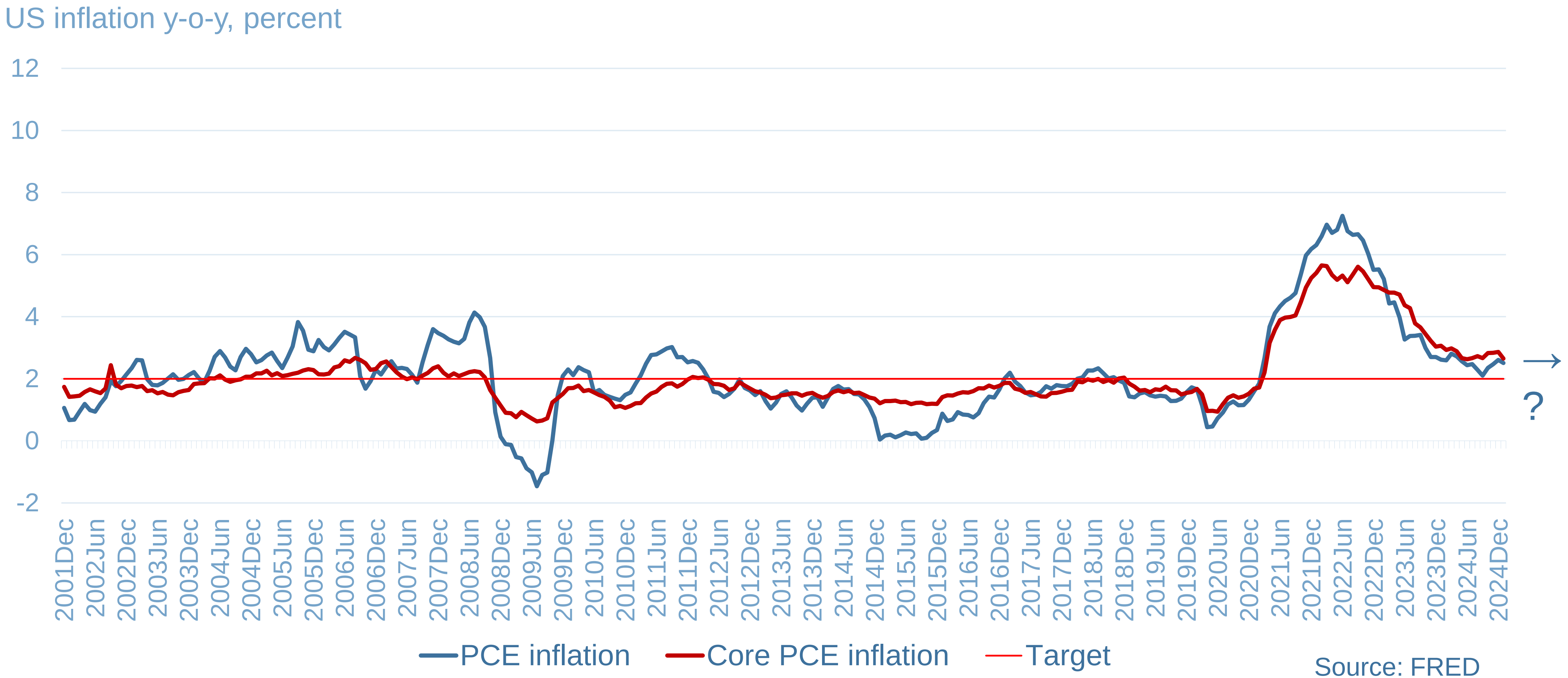
Note: Emphasis added.

- “[T]he recognition that financial stability is a precondition for price stability.”

EA core inflation below target 2009 – 2021



US inflation experience – broadly comparable



Source: FRED

The 2021 review was about the last war

- Symmetric loss function around 2%, possibility of overshoot
- Medium-term focus
- “[E]specially forceful or persistent monetary policy measures” near ELB – maybe not so symmetric?
    - QE – what is transmission mechanism in the euro area, global spillovers?
    - Forward guidance – how to implement?
    - Negative rates?
    - Credit easing?
- The earlier (pre-COVID) Fed review was even more concerned with ELB – “catch-up inflation” idea was mis-timed, and will be revised.

Some lessons of the recent inflation

- Supply factors can drive big short run movements in inflation
- But the *form* supply factors take matters
  - Supply and demand factors interact: Even a smallish demand shock can have big effects if the supply curve has steepened
- Supply shocks face central banks with a tradeoff – implicitly if there is a single mandate – but how to assess existence, size, persistence?
  - "Looking through" is easier to say than to do – a big, too-persistent shock can feed through to expectations, which may now be more sensitive
- Inflation may have evolved differently by country (Bernanke/Blanchard)
- Overall, recent experience worldwide demonstrated the value of central bank independence oriented toward price stability
  - "Last mile" problem not fully resolved, given current disruptions

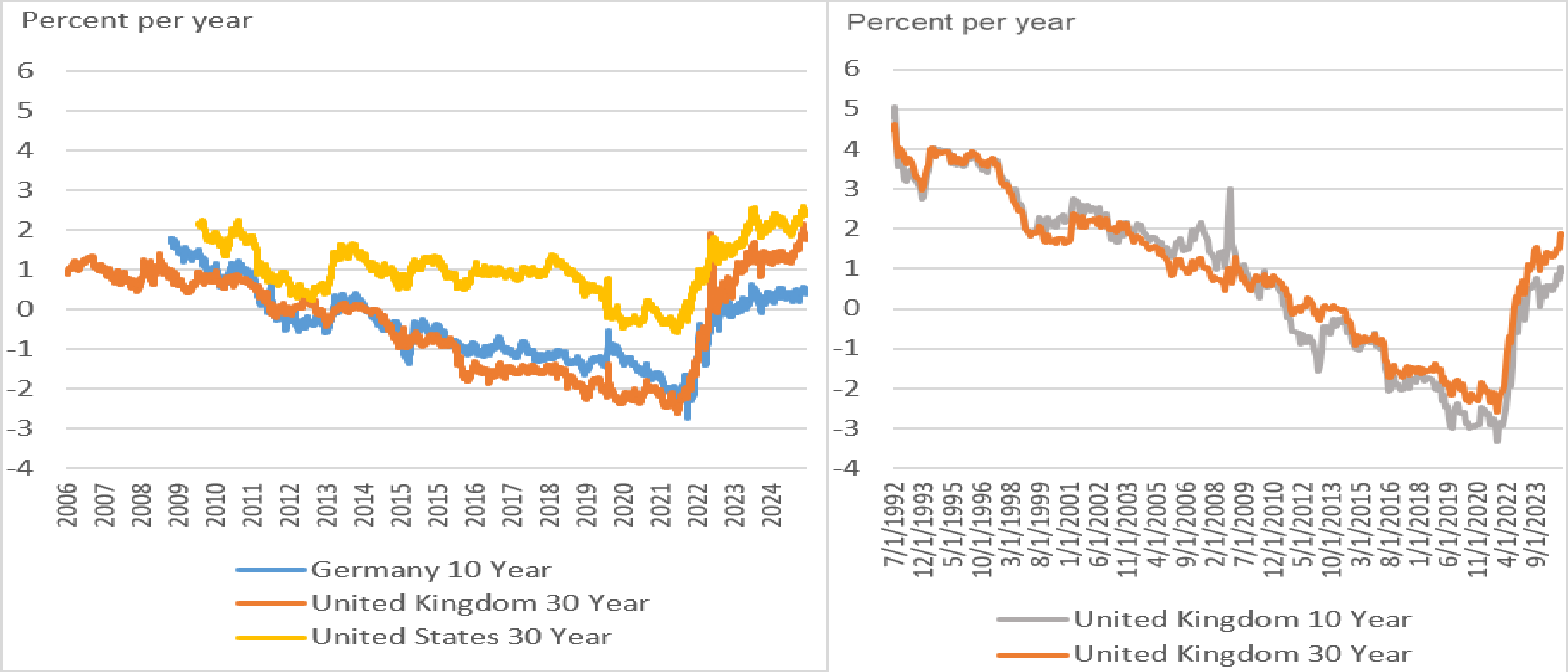
Many questions and hazards going forward

- $\bar{r}$ versus r^*: Has the threat of the ELB receded ($\bar{r}, r^*$ permanently higher) – or is very low r^* still possible, which means proximity cannot be ignored
- Challenges of changed geopolitics and more frequent real shocks after the Great Political Moderation
- Is there a right size of the central bank balance sheet?
- Interventions in the term structure as a policy tool? Cf. US discussion
- Fiscal challenges from persistently higher interest rates – f/m interaction.
- EMU political economy: national debt crises
- Financial stability in general and the LLR/market-maker role
- External pressure over the euro/dollar exchange rate
- Could dollar funding become a vulnerability? – risks of currency mismatch

Factors determining $\bar{r}$

- Demographics likely to support global saving
- Population growth and investment/innovation (C. Jones)
- Fiscal stances in big countries will likely push global r upward
- Fiscal demands owing to aging populations
- Reinforced by needs of green transition, military spending
- Geopolitical fragmentation: Regionally divergent $\bar{r}$?
- But will Gen AI spark a productivity revolution?
- So far, markets suggest $\bar{r}$ back to pre-GFC levels or a bit above

Long-term inflation-indexed yields



(a) Germany, United Kingdom, and United States

(b) U.K. 10- and 30-year maturities

The reason for this rise is all-important

- Temporary result of monetary tightening? If so, ELB difficulties could recur
- Productivity expectations?
- Expected fiscal deficits
- The last explanation could face the ECB with difficult tradeoffs, especially given constraints on action to support debt markets: how to respond?
- The big range of shocks calls for more scenario description – and war gaming
- Structural reforms *à la Draghi* would help – perhaps the time is finally ripe?

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Thank you.

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