ECB Policy Strategy: Some Remarks

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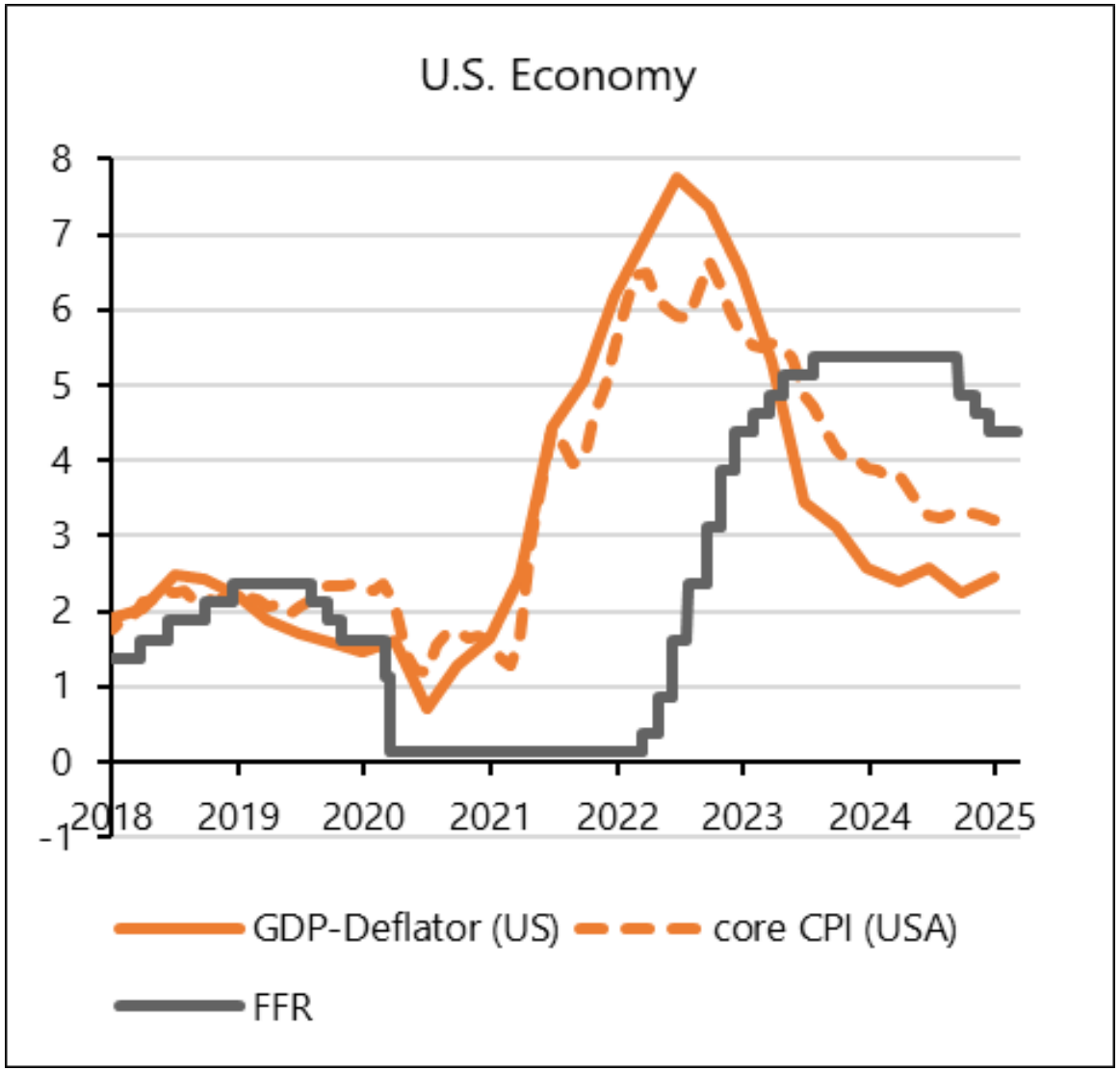
ECB Policy Strategy: Some Remarks

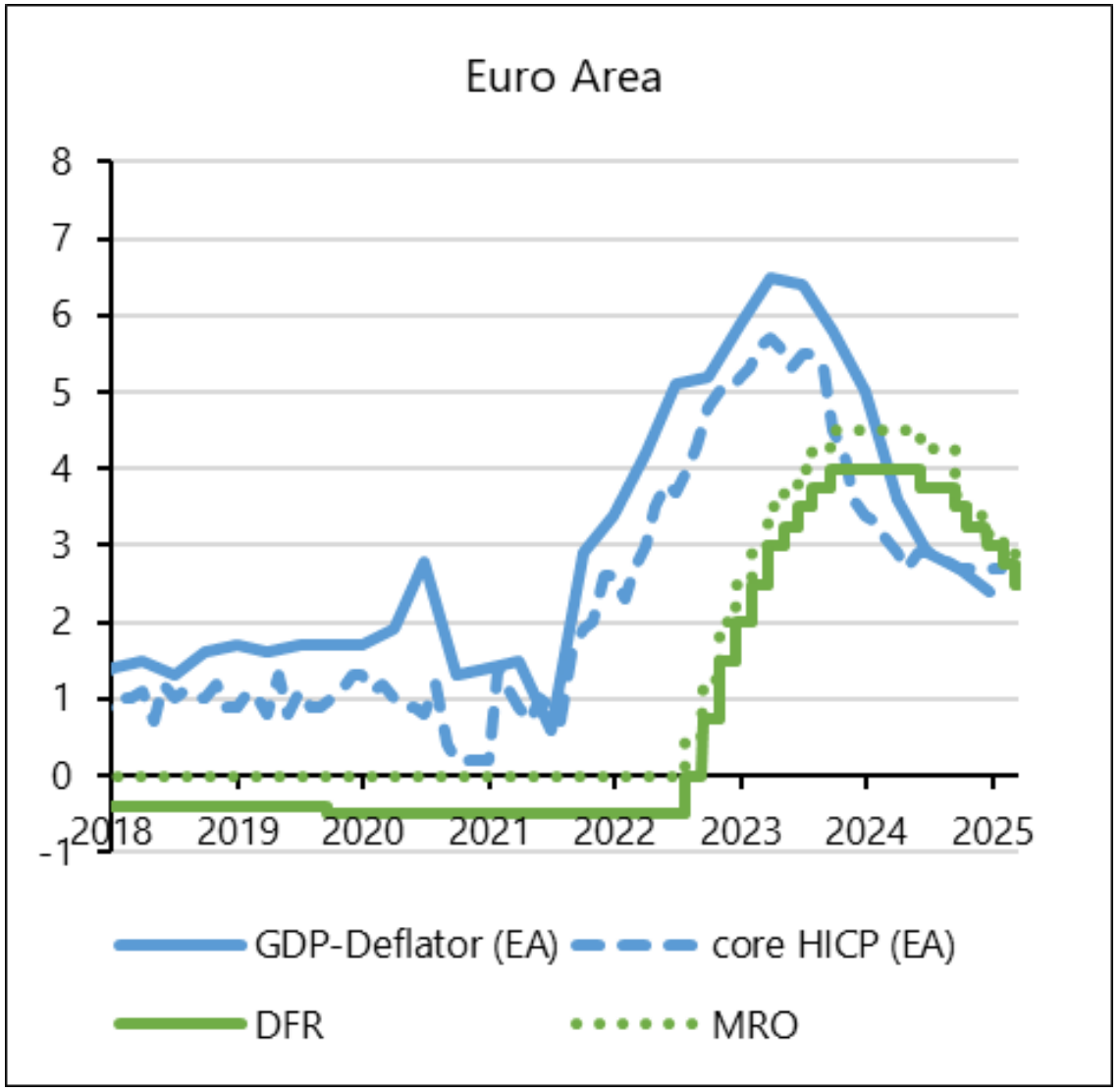
I. Policy during the surge and decline of inflation vs before
   - Hegemann and Wieland (2025)

II. Simple rules providing (forward) guidance
   - Tatar and Wieland (2024a,b)

III. Some conclusions

Policy during the surge and decline of inflation





Reasons for late response: Forward guidance

Fed: Sep 2020: *with inflation running persistently below this longer-run goal, the Committee will **aim to achieve inflation moderately above 2% for some time** so that inflation averages 2% over time and longer-term inflation expectations remain well anchored at 2%. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved.*

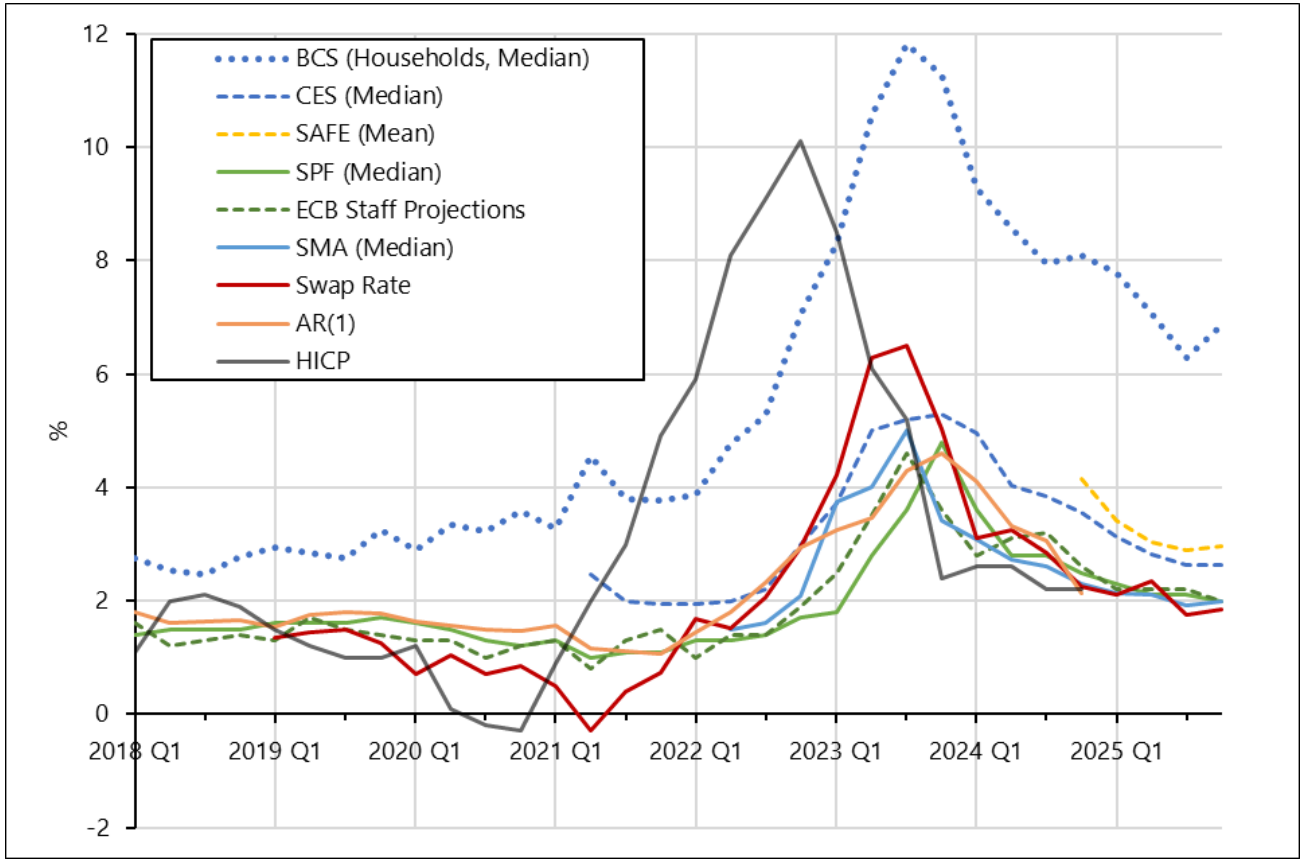
ECB: July 2021: … *in line with our monetary policy strategy, the Governing Council expects the key ECB interest rates to remain at their present or lower levels until we see inflation reaching 2% well ahead of the end of our projection horizon and durably for the rest of the projection horizon, and we judge that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. This may also **imply a transitory period in which inflation is moderately above target**.*

Reasons for late response: Forecasts

ECB Sep 2021: *The current increase in inflation is expected to be largely temporary and underlying price pressures are building up only slowly. The inflation outlook in our new staff projections has been revised slightly upwards,*

but in the medium-term inflation is foreseen to remain well below our 2% target.

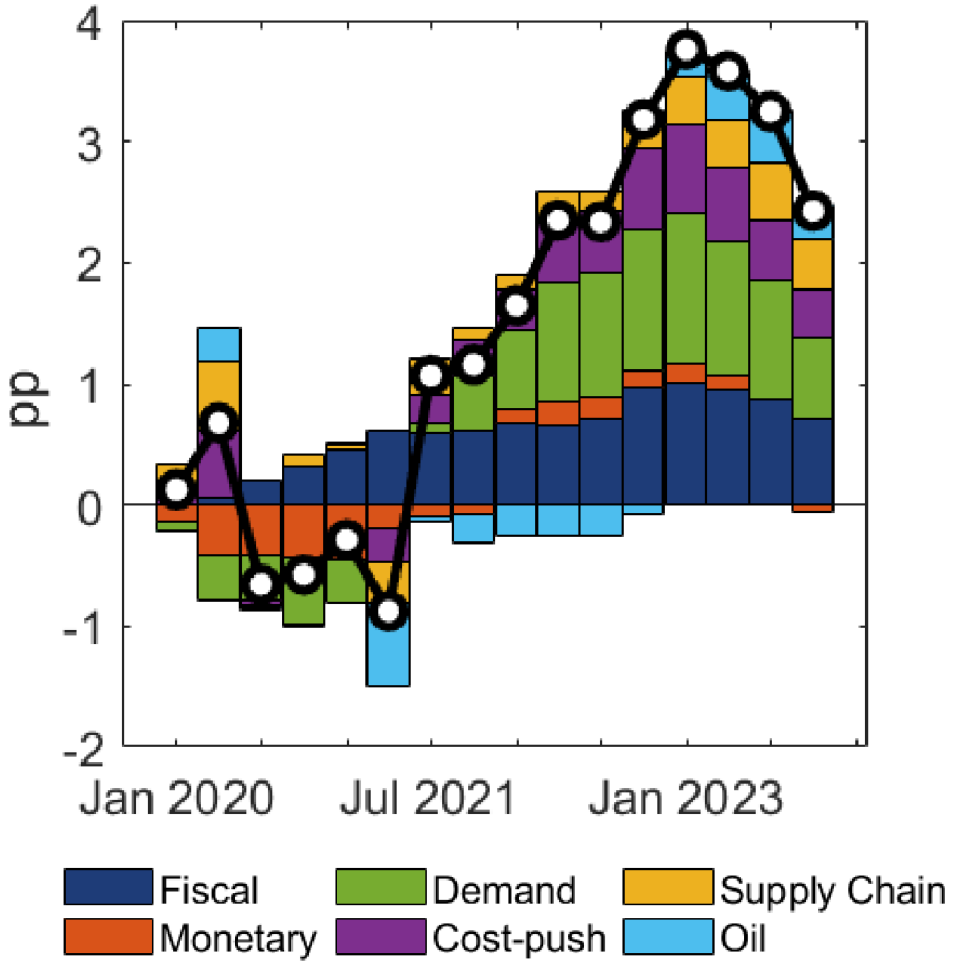
1-year ahead euro area HICP inflation vs forecasts (shifted to match with predicted data)



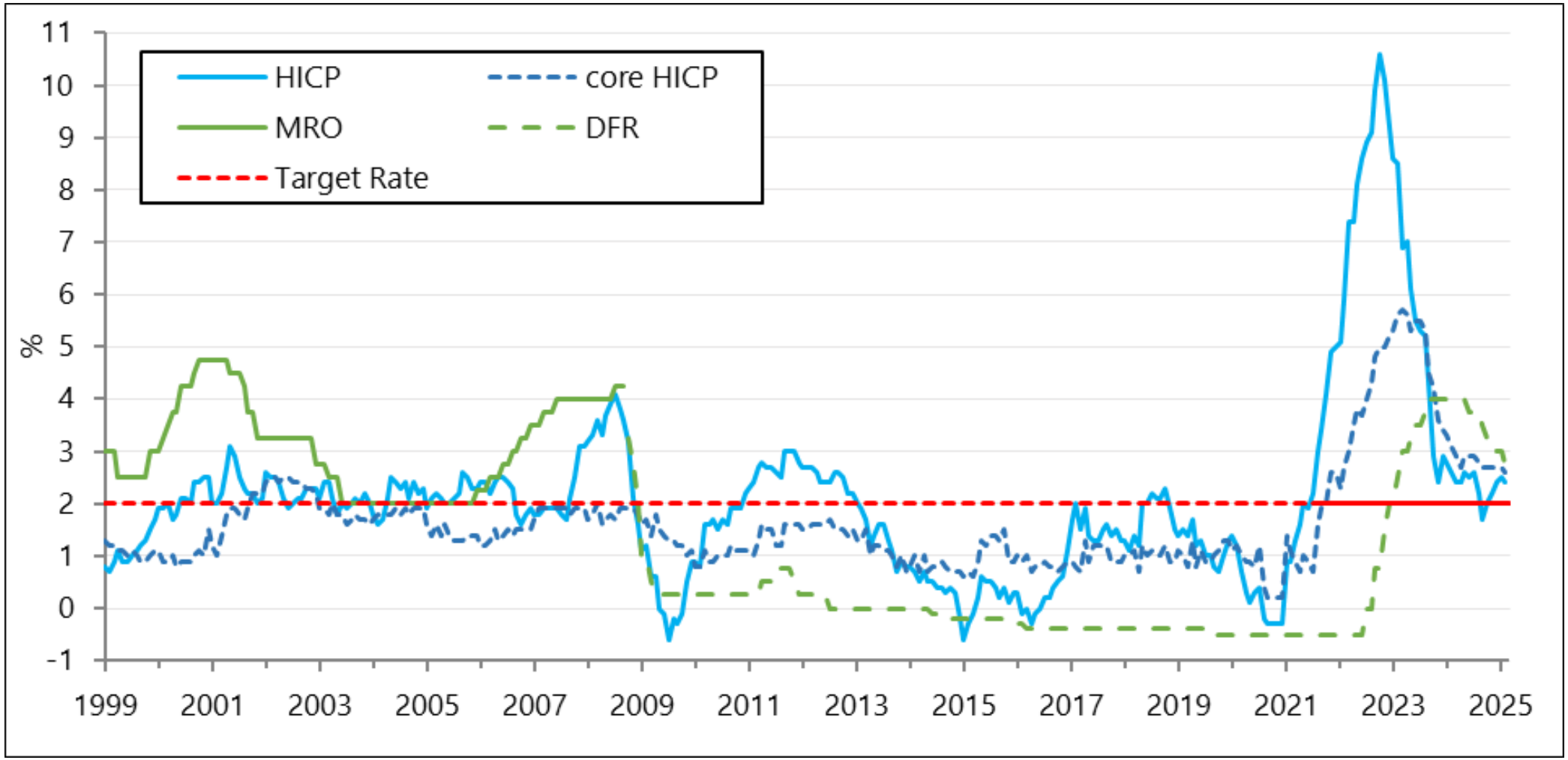
Recent studies suggest that demand-side forces contributed importantly to inflation surge

- Recent studies by Barro and Bianchi (2023), Dynan and Elmendorf (2024), Giannone and Primiceri (2024) and Ascari et al (2024) contradict the view that it was exclusively or primarily Putin‘s inflation
- Demand side stimuli, including fiscal and monetary policy have contributed substantially
- Example from Ascari et al. 2024.

Inflation (GDP Deflator) Euro Area



ECB policy rates relative to consumer price inflation: 1999-2025



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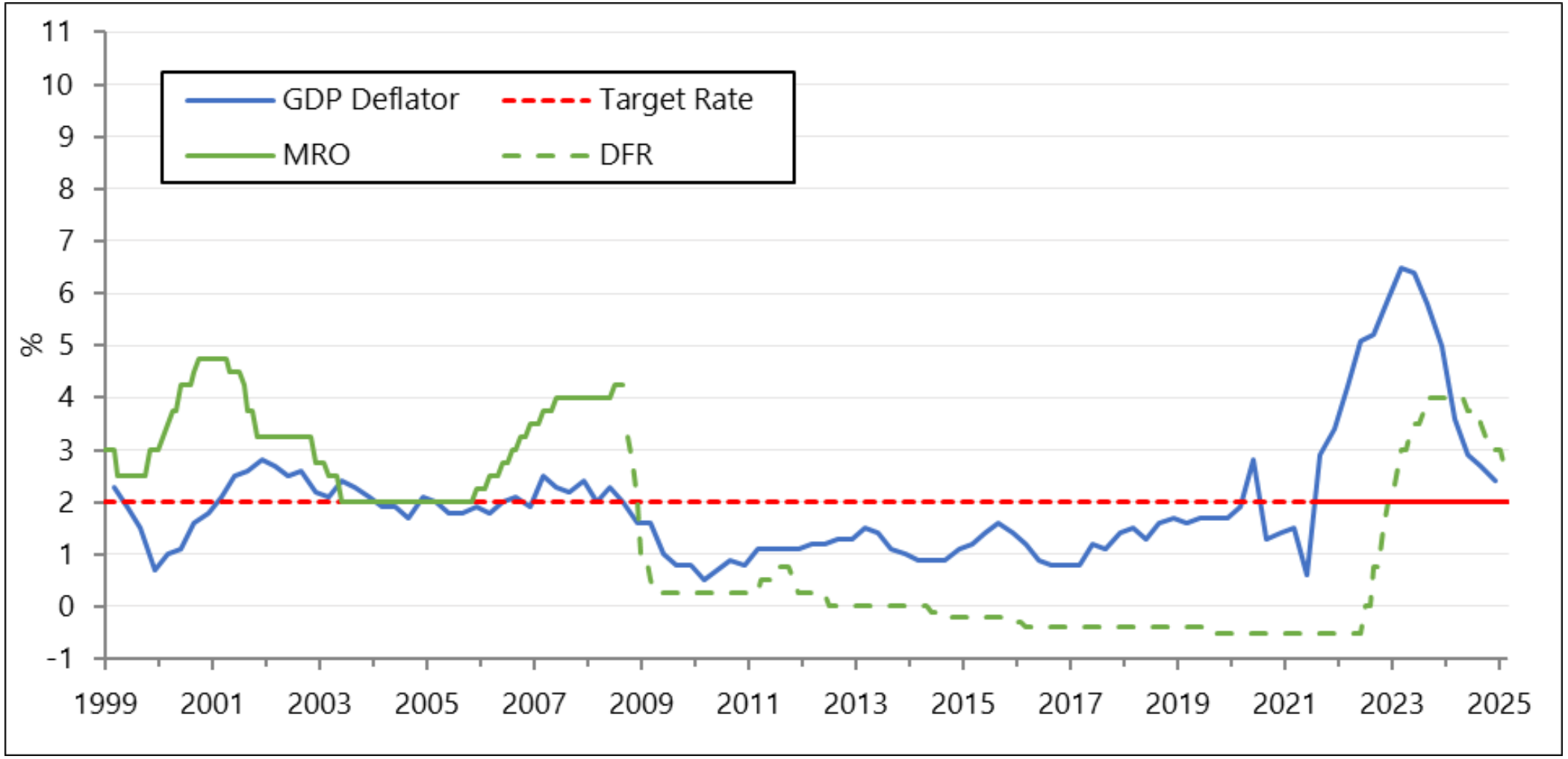
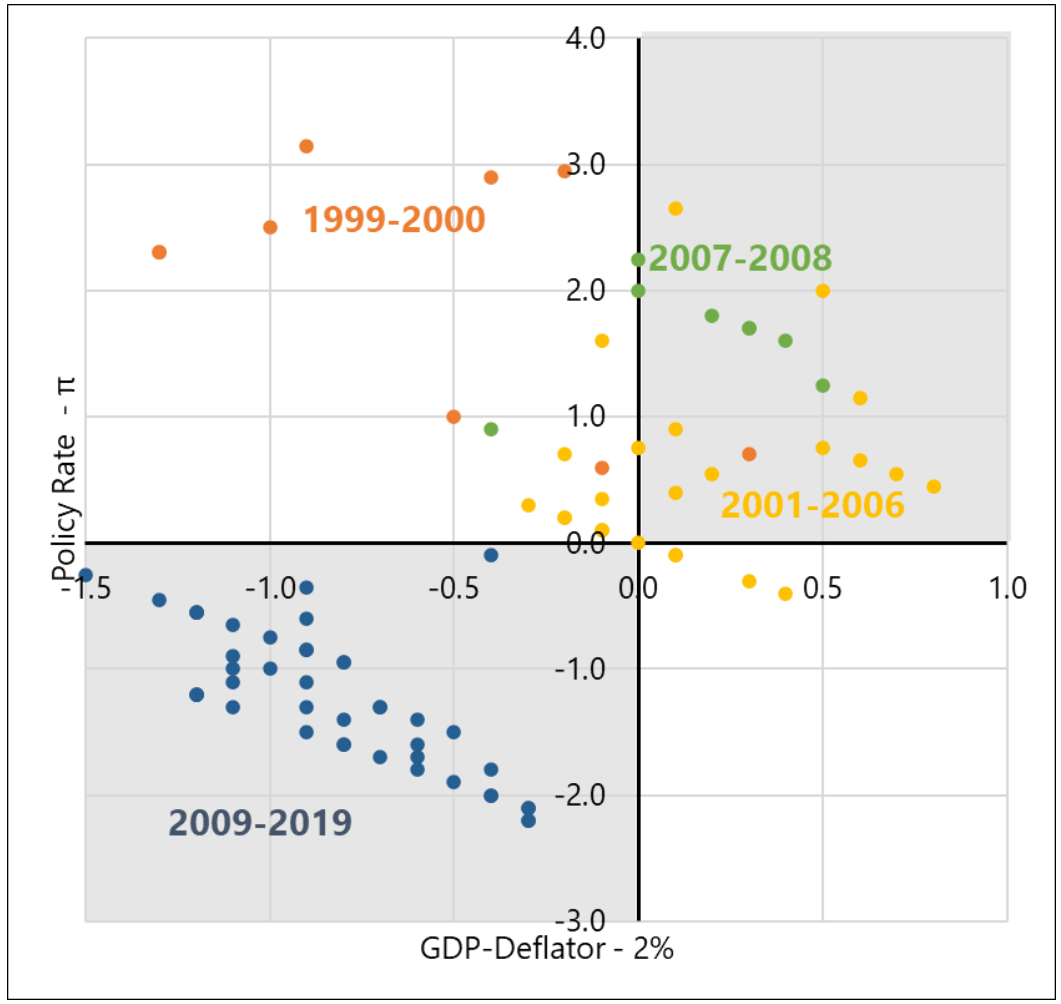
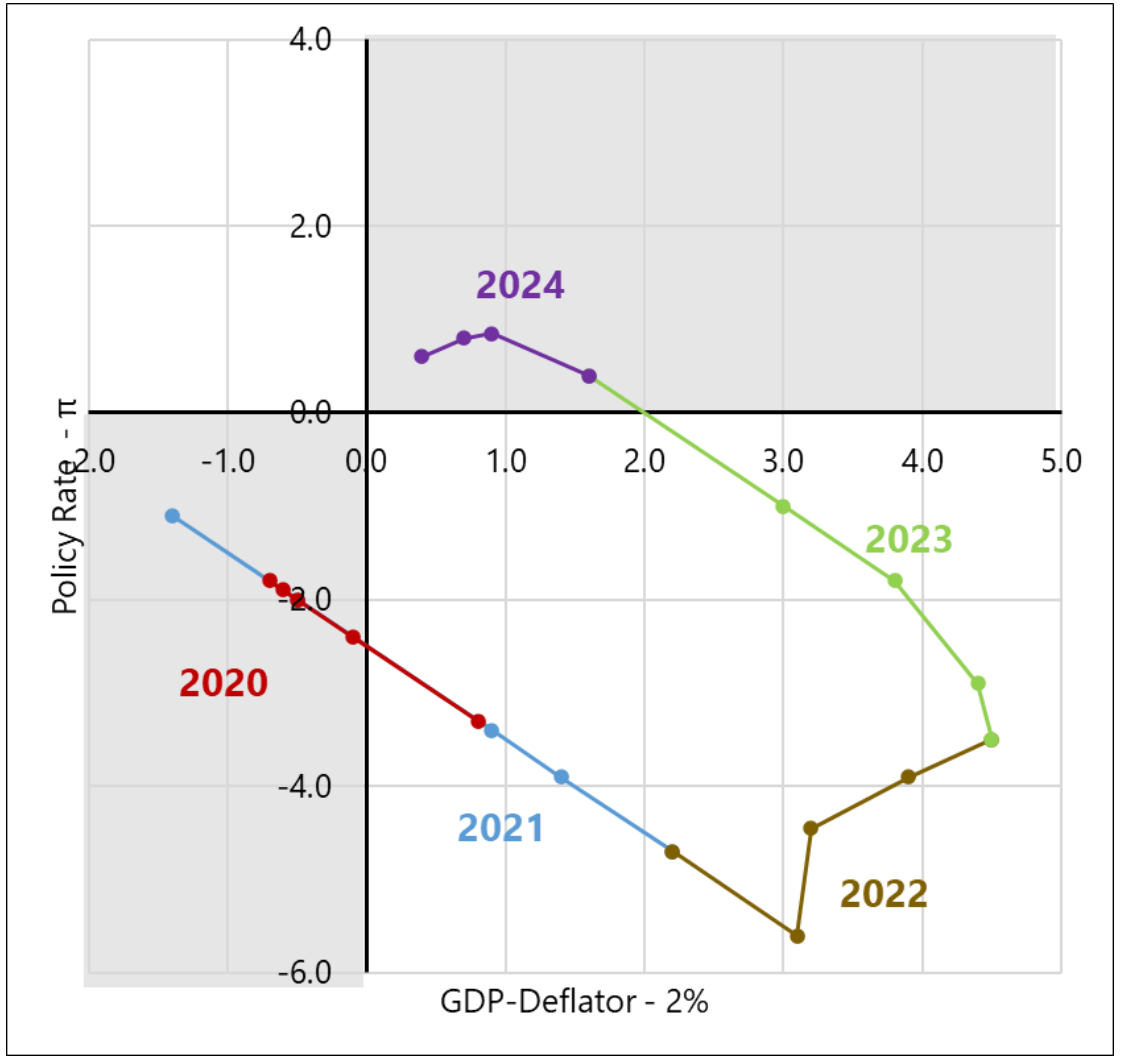
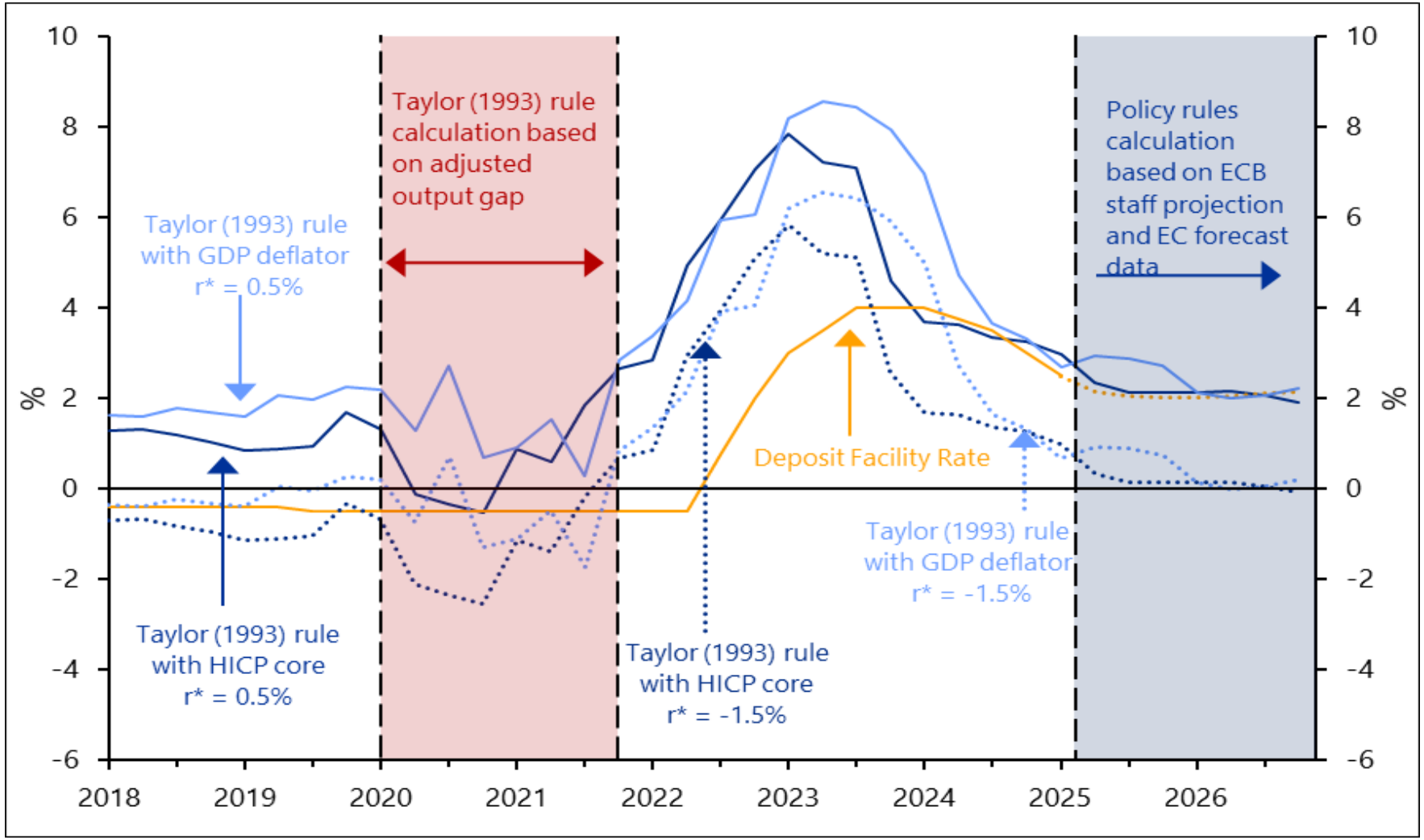


Taylor principle: Real policy rates vs (domestic) inflation gap

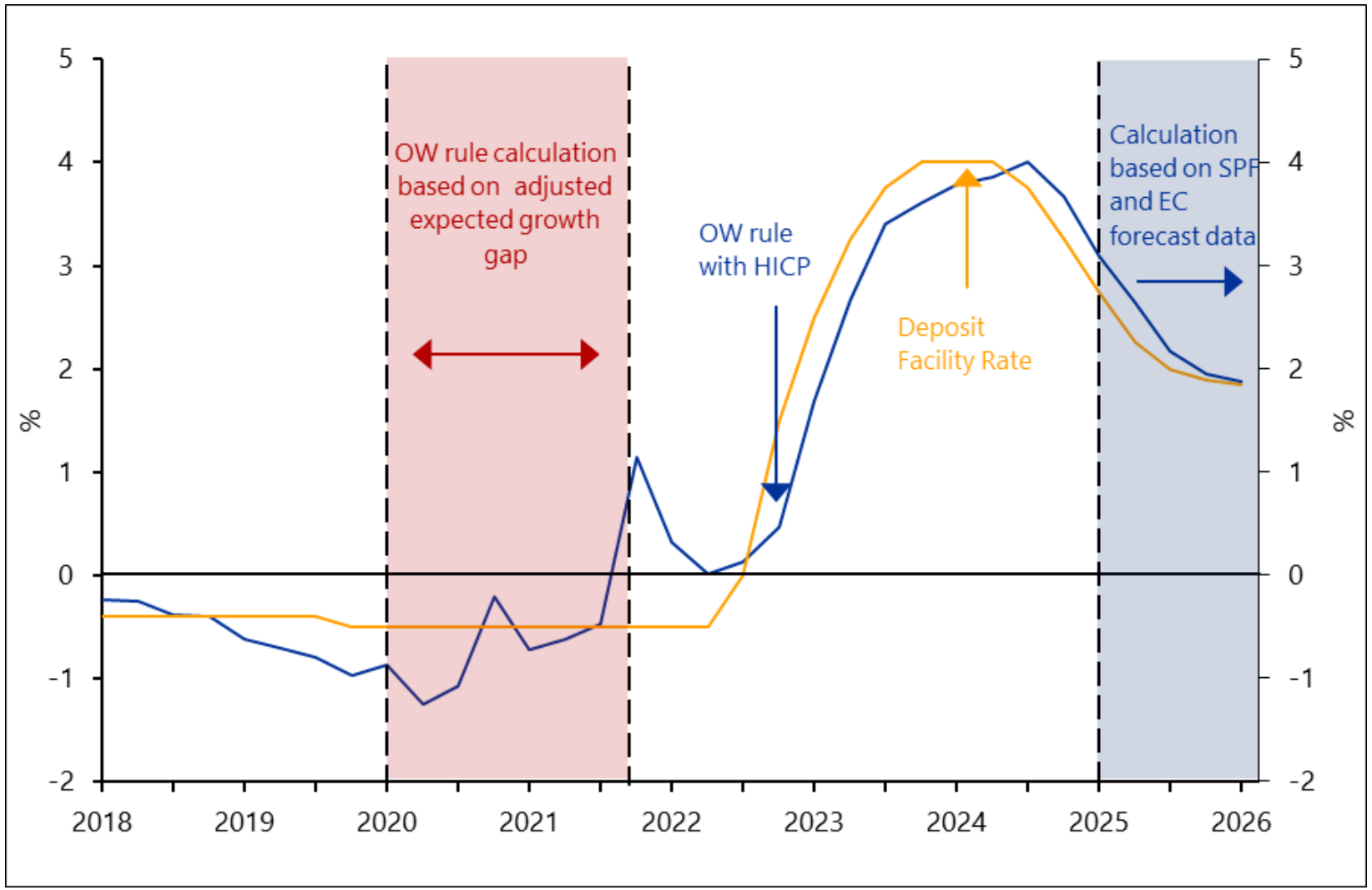




2) Taylor (1993) rule: $i_t = r^* + \pi_t + 0.5(\pi_t - \pi^*) + 0.5(q_t - q_t^*)$



OW rule (2013): $\Delta i_t = 0.5\left(\pi_{t+3|t} - \pi^*\right) + 0.5\left(q_{t+2|t} - q^*_{t+2|t}\right)$

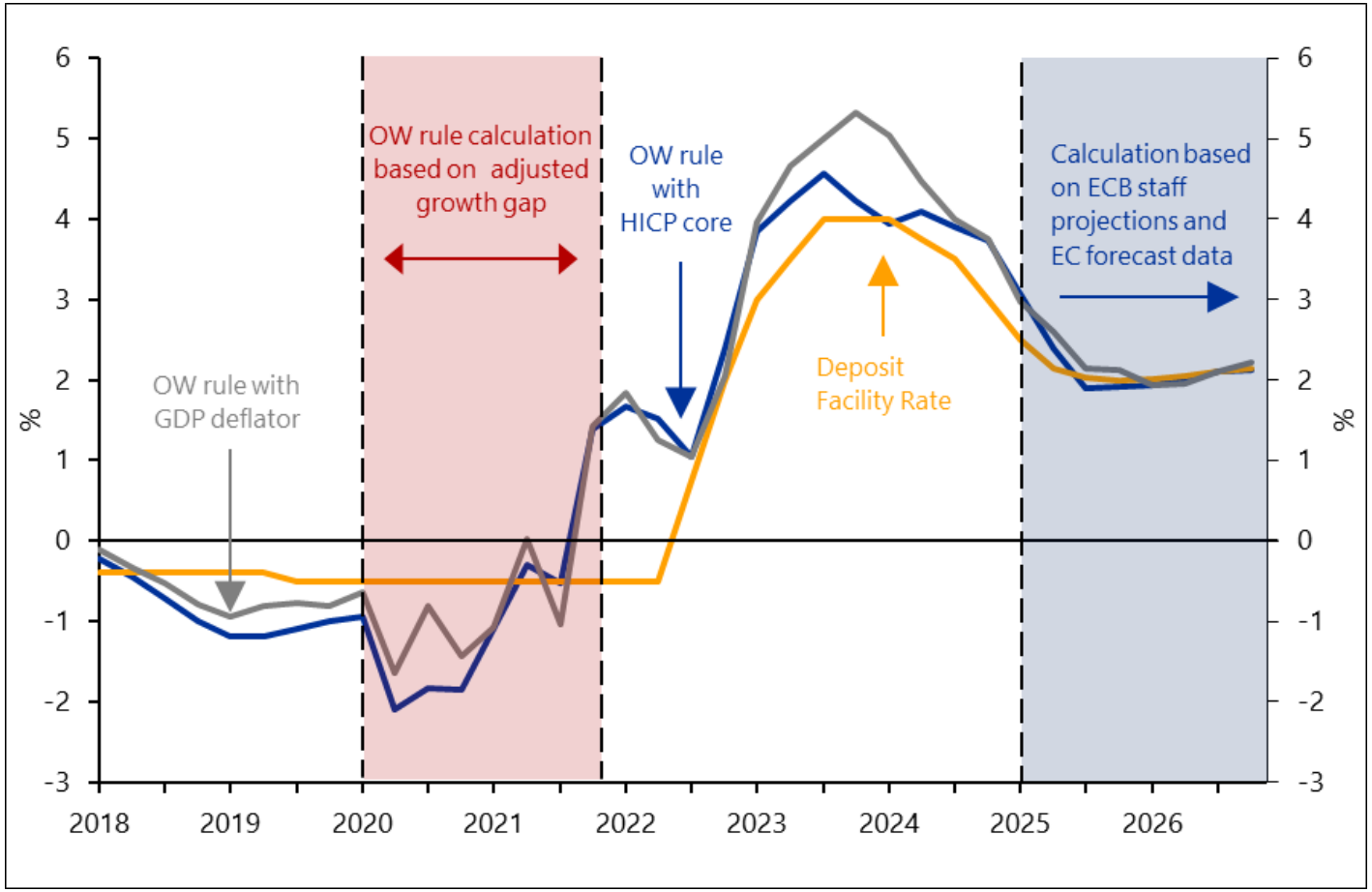


OW rule based on recent outcomes

OW 2013 model-based evaluation found:

a simple difference rule with coefficients of 1/2 on inflation and output growth deviations, just like the rule shown to be useful for interpreting ECB interest rate policy,

is quite robust as long as it responds to current outcomes rather than forecasts."

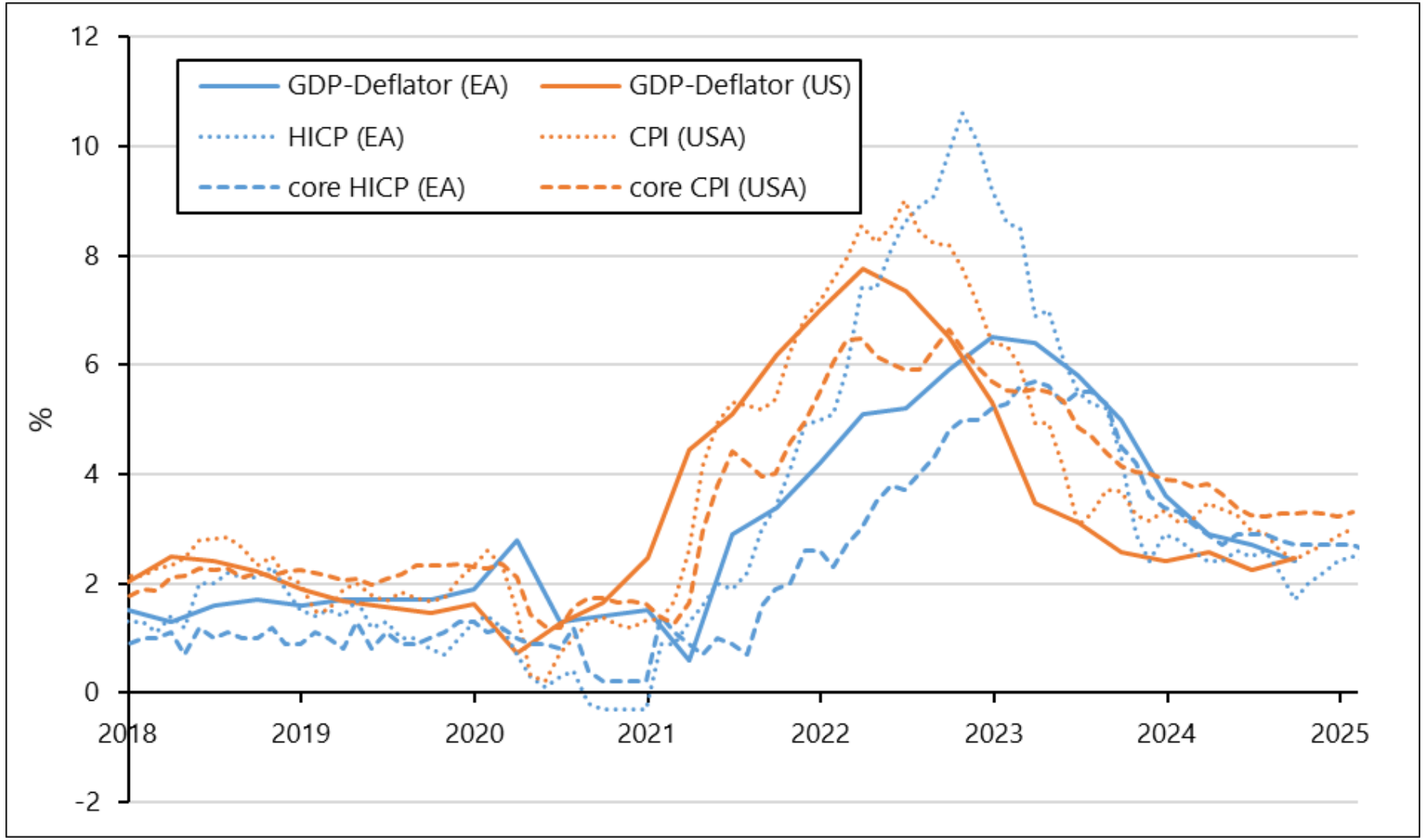


3) Some recommendations

- Give less weight to medium-term forecasts, more focus on near-term observations, nowcasts/outcomes
- Avoid fixed forward guidance
- Give more weight to Taylor principle in policy strategy
- Give more weight to simple (nowcast/outcome-based) rules as benchmarks for policy deliberations.
- Publish rule prescriptions. Rules can serve as state-dependent forward guidance
- Alternatively/additionally, publish survey of decision maker forecasts for inflation, growth and interest rates

Appendix

The surge and decline of inflation: Euro area vs United States



Applying Taylor and OW rules to the euro area

Taylor (1993) rule includes an equilibrium real interest rate r^*, the inflation rate π, the target π^* and the output gap—the deviation of the logarithm of GDP, q_t, from the logarithm of potential GDP, q_t^*.:

$$i_t = r^* + \pi_t + 0.5(\pi_t - \pi^*) + 0.5(q_t - q_t^*)$$

First-difference rule from Orphanides and Wieland (2013) (OW rule) has been found to fit past ECB decisions fairly well (Bletzinger and Wieland (2017), Hartmann and Smets (2019) and Tatar (2023)). It relates the change of the interest rate to SPF forecasts of inflation (relative to the target) and output growth (relative to the European Commission's estimate of potential growth):

$$\Delta i_t = 0.5\left(\pi_{t+3|t} - \pi^*\right) + 0.5\left(q_{t+2|t} - q^*_{t+2|t}\right)$$