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Policy Brief 1/2020

LUISS

January 10, 2020

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Over the past eight years the European Central Bank has systematically failed to achieve its primary objective of price stability, defined as a rate of inflation "below but close to 2%". This has raised several criticisms of the monetary policy implemented by the ECB. The new ECB President, Christine Lagarde, who took office on 1 November 2019, decided to launch a comprehensive review of the monetary strategy, to be conducted in the course of 2020.

One of the issues that is likely to be debated in this context is the definition of price stability that the ECB sets for itself. At the start of monetary union, in 1999, the ECB defined price stability as a rate of inflation "below 2%". The issue was revisited in 2003, when the definition was clarified to be a rate of inflation "below but close to 2%", to address potential deflationary risks.

The debate around the strategic review has already started. Some observers, including central bankers,[1] proposed to keep the definition of price stability unchanged, at 2% or slightly below, but to allow for some flexibility by adopting a range, for instance 1-3%. A range would have the advantage of providing the central bank with more time to reach its target, thus avoiding the adoption of measures that could have undesired collateral effects. It would also allow for structural factors and unexpected shocks – such as globalization, demographics or technology - to be duly accounted for.

A change in the inflation target would, however, have important consequences for the accountability of the ECB. It could also affect its independence, given that any persistent and unexpected fluctuations of the inflation rate within the range would have distributional effects, in particular between creditors and debtors. It would also impact the functioning of financial markets by making the anchoring of inflation expectations – and thus the formation of asset prices – even more complex. Doubts would also be raised about the time-consistency of setting a target range if the central bank did not have the same incentive to tolerate inflation in the upper range compared to the lower one.

In any case, before even addressing the pros and cons of such a proposal and considering possible changes in the strategy, there is a need first to understand the reasons why the ECB was not able to reach the prevailing target. A preliminary question that needs to be answered is whether the

[1] Klaas Knot, "The quest for policy scope - implications for monetary policy strategies" Fourth annual high-level conference "Racing for Economic Leadership: EU-US Perspectives", New York City, 16 October 2019. Benoit Coeuré, "Monetary policy: lifting the veil of effectiveness", ECB colloquium "Monetary policy: the challenges ahead", Frankfurt am Main, 18 December 2019.

measures adopted by the ECB over the recent years were consistent with the aim to achieve an inflation rate below but close to 2%. Indeed, any change in the strategy would require that the hypothesis according to which the ECB might not have done whatever was needed to achieve its price stability objective be first rejected.

The hypothesis is pertinent since the ECB performed worse than the other major central banks. The cumulated deviation from the 2% inflation target during the 2013-19 period amounted to 7 percentage points, against 2 for the Federal Reserve, the Bank of Canada and the Bank of England. Among the major central banks only the Bank of Japan performed slightly worse.

This note presents evidence suggesting that the hypothesis according to which the ECB might not have done whatever was needed to achieve its price stability objective cannot be easily rejected and needs to be considered carefully. The evidence is based on a relatively simple set of indicators. The intention is to stimulate a more thorough analysis of the policies that have been implemented in recent years. Counterfactual policy analysis is obviously very complex. However, it is interesting to note that while several authors[2] – including those within the ECB - have concentrated their efforts on assessing what would have happened to growth and inflation had monetary policy been less expansionary, there is yet little work on the opposite scenario, i.e. of what would have happened if monetary policy had been more expansionary in a more timely way.

The results obtained in the literature so far suggest that the ECB's policies over the last eight years have significantly contributed to raising growth and inflation. This should imply, by analogy, that a more expansionary monetary policy and a different sequence of measures would have raised growth and inflation even further, thus bringing the performance of the Eurozone economy closer to its targets. This suggests that further work is needed.

This suggestion is confirmed by a small set of indicators.

A first indicator is the systematic overestimation of Eurozone inflation and growth in the ECB's projections. The ECB's forecasts, in particular from 2013 to 2016, show that the inflation and growth projections over the horizon relevant to monetary policy were systematically too optimistic. This has been openly recognized, as shown in figure 1.[3]

[2] Massimo Rostagno, Carlo Altavilla, et al..., "A tale of two decades: the ECB's monetary policy at 20", Working Paper 2346, December 2019.

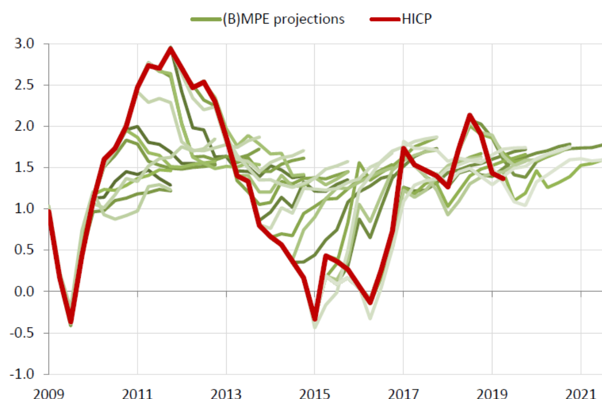
[3] Benoit Coeuré, "Inflation expectations and the conduct of monetary policy", SAFE Policy Center, Frankfurt am Main, 11 July 2019.

Figure 1

Predicting inflation is often a challenging process, both for central banks…

HICP inflation: realised and Eurosystem projections

(% per annum)



Sources: ECB and Eurostat.
Latest observation: 2019Q2.

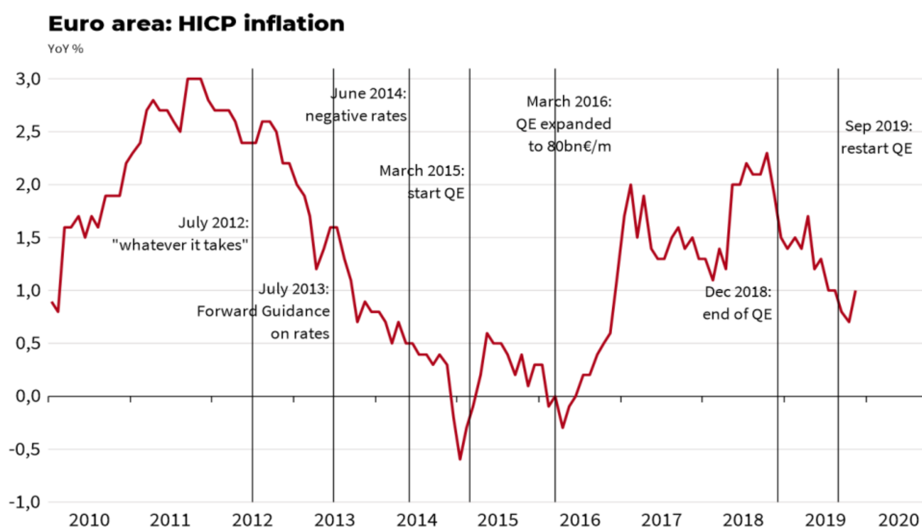
Given that monetary policy is calibrated on the forecast of inflation over the relevant policy-horizon – typically 12 to 18 months ahead – an overestimation of inflation implies that monetary policy is bound to be too restrictive. A systematic repetition of the forecast error implies that monetary policy will be too tight for too long. Had the forecasts been more accurate, it would have been evident at the time that the prevailing monetary policy stance was insufficiently lax to bring inflation back towards a level consistent with price stability and that a more aggressive easing was necessary.

To be fair, the ECB was not the only institution to overpredict inflation and growth. For instance, in the Fall of 2013 the European Commission forecast a rate of inflation for the Eurozone of 1.5% in 2014 and 1.4% in 2015, not significantly different from the ECB, against an outcome of 0.4%% and 0.0% respectively. The impacts of the financial crisis, triggered by the Greek debt restructuring and the spread of the redenomination risk, have been severely underestimated. There is evidence that market participants also made significant forecast errors during the period.

To be sure, insufficient work has been devoted to explaining why most macro-economic models have overpredicted Eurozone growth and inflation, starting from the double-dip recession of 2012-13 and continuing with the slow recovery and low inflation between 2013 and 2016. Insufficient work has been devoted also to repairing these models to ensure that such mistakes are not repeated. It is not the purpose of this paper to dwell deeper on this issue. However, it is undeniable that with the benefit of hindsight the monetary policy stance in the Eurozone was too restrictive for a long time. In light of the above, it seems that central bankers should dedicate their work to improving their tools for understanding and forecasting economic trends rather than to changing the target of their policies.

The second indicator suggesting that monetary policy was insufficiently expansionary derives from the observation that inflation remained well below 1% for more than three years, between the second half of 2013 and the end of 2016 (fig.2). This suggests that even when using a more flexible definition of price stability, based, for instance, on a 1-3% range, as some now propose, the hypothesis that monetary policy was not sufficiently expansionary to achieve price stability cannot be easily rejected.

Figure 2



The third indicator is based on inflation expectations (fig 3). The indicator of 5-years ahead 5-years inflation expectations derived from asset prices suggests that monetary policy was not loosened quickly enough, in particular in 2013. It also suggests that the sequence of instruments used by the ECB to implement a more expansionary monetary policy was not effective.

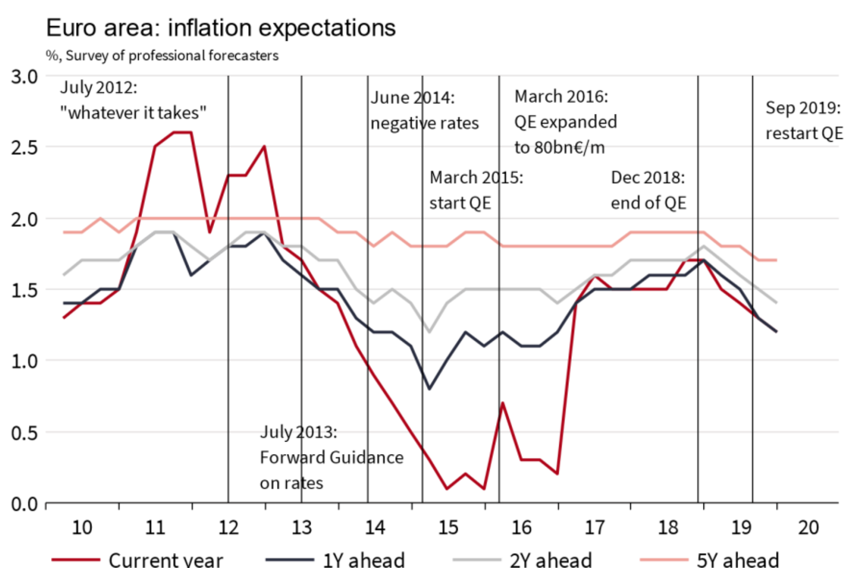
Figure 3

The data show that inflation expectations remained relatively well anchored between 2 and 2.5% until mid-2013 and started declining sharply thereafter. This suggests that the July 2013 decision by the ECB to adopt a policy of forward guidance was not effective in avoiding a dis-anchoring of expectations. Several observers noted at the time that such a policy was inadequate and possibly time-inconsistent.[4] Ex-post evidence, collected notably by the ECB, confirms this assessment. The ECB stuck to this policy despite the continued fall of inflation expectations. In mid-2014 the ECB decided to cut interest rates into negative territory, while inflation expectations collapsed, in spite of calls by several observers to start quantitative easing.[5] Inflation expectations stabilized around 1.5% only after the ECB decided to embark on its Asset Purchase Program, in March 2015.

Interestingly, inflation expectations decreased again in early 2019, after the ECB stopped its asset purchase program, and appeared to stabilize towards the end of the year, after the restart of the Program.

The data on inflation expectations extracted from asset prices can display some distortions due to methodological issues. However, using other measures of expectations, such as the survey of professional forecasters, does not substantially change the assessment. Figure 4 shows that inflation expectations on the current year and one and two years ahead disanchored in mid-2013 and stabilized only after the start of QE, in March 2015.

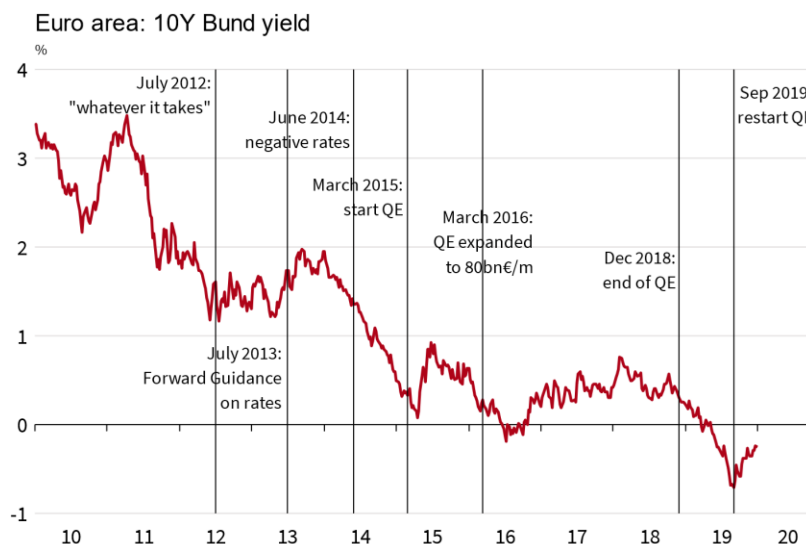
Figure 4



[4] L. Bini Smaghi "Why forward guidance has failed to convince", Financial times, 10 September 2013.
[5] L. Bini Smaghi, "Reasons to favor quantitative easing", Financial times, 27 March 2014.

Interestingly, the same conclusions can be reached by looking at the 10-year Bund yield (figure 5). Several German commentators blame the ECB for having implemented a too lax monetary policy, which produced a sharp decrease in the return over their safest investment. Instead, the opposite seems to be true.

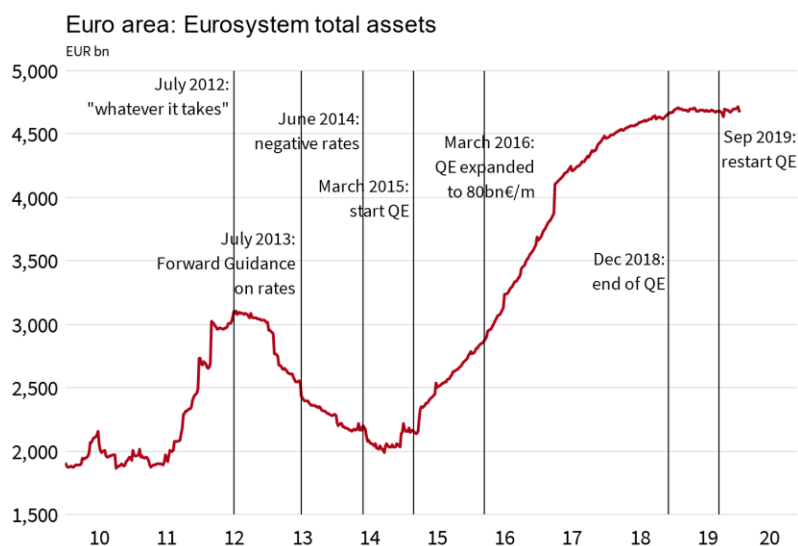
Figure 5



Bund yield started falling in 2011, as a result of the Eurozone crisis which led investors to move their portfolio allocation away from peripheral Government bonds towards Bunds. The reduction in yields ended in the Summer of 2012, following the "whatever it takes", but resumed again in the second half of 2013, in spite of the forward guidance and the cut in interest rates into negative territory. Bund yields started rising again after the start of the Asset Purchase Program, in March 2015. It is interesting to note that the sharp reduction in German long-term rates started again at the end of 2018, when the ECB stopped its APP, as the 10-year rate moved from .20% to -0.5% in less than 9 months. The rate stabilized and started rising after the ECB announced the re-start of QE.

The final indicator, which confirms the previous assessment, looks at the evolution of the ECB's balance sheet, which measures the amount of central bank money circulating in the financial sector (fig 6). At the zero-lower bound, the size of the balance sheet also shows the degree of monetary stimulus injected into the economy. Interestingly, after the end-July 2012 "whatever it takes" announcement, the size of the central bank's balance sheet shrank sharply, from over 3 tn euro to 2.5 tn in less than 12 months. The strong reimbursement of LTRO in early 2013 was initially interpreted as a sign that the banking system was healing. It might have not been fully understood that the reduction of the Eurosystem balance sheet to the levels prevailing before the crisis was reflecting overly restrictive monetary conditions rather than a return to a better functioning of the interbank money market.

Figure 6



The decision to implement forward guidance in mid-2013 and to cut rates into negative territory did not stop the shrinking of the ECB's balance sheet. In fact, given the instruments used by the ECB to issue central bank money, its quantity was endogenously determined by banks' demand, which was falling due to the slow pace of economic activity and the sharp deleveraging process implemented by the Eurozone banking system. The bank deleveraging was not fully acknowledged by the ECB at the time, as supervisory information was still in the hands of the national authorities. The Banking Union and the creation of the Single Supervisory Mechanism within the ECB were implemented only at the end of 2014. Their effects were felt much later.

To sum up, the evolution of the above variables suggests that monetary policy was eased too late and the sequence of instruments was not the most efficient one. Forward guidance was not very effective in influencing market expectations and the interest rate cuts were delayed for too long. The Asset Purchase Program should have been adopted much earlier, at least by mid-2013. The reasons for these shortcomings are not clear. One hypothesis is that the pecking order in which the policy instruments were adopted was based more on the consensus they received within the Governing Council rather than on their effectiveness. There was, for sure, much less opposition to forward guidance and negative rates than to the APP. This seems to be confirmed by the accounts of the meetings, which suggest that unanimity failed to materialize only when the APP was decided. Most probably, in mid-2013 the Governing Council did not want to embark on another controversial decision, only twelve months after the divisive decision on OMT. It thus preferred to agree on a low hanging fruit, such as forward guidance, rather than dividing itself around quantitative easing. By mid 2014, the Governing Council might have expected that a decision to cut policy rates into negative

territory would be less controversial and might stimulate monetary conditions to such an extent that it would avoid having to embark on QE, like other central banks had done a few years earlier. This expectation turned out to be wrong and the system cumulated the effects of QE with that of negative rates. With the benefit of hindsight, the search for consensus might have led the ECB to delay the Asset Purchase Program for too long. Such a delay contributed to maintaining excessively tight monetary conditions, which partly explains why the inflation target was missed.

Another reason why monetary accommodation may have been unduly delayed is the idea, popular among some policy-makers, that the central bank should “keep its powder dry” and not use all its firepower in order to have room for addressing possible future contingencies.[6] This view has been aired repeatedly to suggest that the ECB should avoid cutting rates too quickly or embarking on QE. With the benefit of hindsight, this view proved to be wrong, as it implied implementing a more restrictive monetary policy just with the aim of being more expansionary later on, if needed. The need did indeed materialize, as proved by the undershooting of the target, but the decision was late.

To conclude, the decision to review the ECB’s policy strategy is certainly welcome. It needs, however, to start by understanding why the inflation target was missed for such a long time. A thorough analysis may suggest that the main reason is not that the objective was overly ambitious but rather that the actions were insufficient and overly delayed. This might have been due to several factors, such as an outdated analytical framework for forecasting inflation, an inefficient decision-making process and an insufficient flow of information between the monetary and supervisory arms of the central bank in a period of deep restructuring of the Eurozone financial system.

If this diagnosis is correct, any strategic ECB review should start by addressing these shortcomings rather than succumbing to the temptation of lowering the bar because of a failure to deliver.

[6] For instance, Klaas Knot stated in an interview with Bloomberg on 29 August 2019: “Not reactivating the asset-purchase program also means you keep some powder dry for when actually future contingencies happen.”