Prospects

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The point of view

The ECB's missed opportunity: gearing up for the next war… or the last one?

Expectations as regards changes in the ECB's monetary policy reaction function were modest. Most observers had priced in the fact that the conclusions of the ECB's strategic review would not go as far as those of the Fed in terms of changing the institution's objectives and instruments.

And the Fed had already delivered a dose of disappointment. Its new average inflation targeting strategy lacked precision: by not specifying the time period over which the average was calculated, it left lingering uncertainty (quickly captured by markets) as to just how far the US central bank would be prepared to tolerate higher inflation. Moreover, while the Fed's strategic review provided an explanation of the past dynamics that had resulted in lower inflation and a lower equilibrium interest rate, it did not ask many questions about the future and whether those trends could and should be projected forwards.

For the ECB, the need to develop a shared narrative about why its target had been consistently missed in the past was even more pressing: its credibility was on the line more than the Fed's. The ECB has less flexibility to act, and the consequences – not only redistributive but also political – of divergences in national inflation trajectories are more significant in a monetary union. An analysis of the drivers of these divergent price, income and productivity trajectories and their impact on the conduct of monetary policy would have been desirable.

The ECB has clearly identified that a large part of the reason why inflation is less sensitive to monetary policy and economic activity lies in the slippage in inflation expectations. To anchor inflation expectations, it is therefore necessary to develop a very clear narrative on past mistakes, the over-dependence of the ECB's policy on the personality and beliefs of its governor, the causes of this slippage and the way past inflation influences future inflation.

But looking at the past is not enough. A strategic review must, by definition, be forward-looking, since it will shape action to be taken over the coming decades. Monetary policy must be based not on what has happened but on what will happen. The resulting policy trajectory is both pre-emptive and time-consistent.

We know that, in the period that followed the great economic and financial crisis, slack in the economy was underestimated, the equilibrium interest rate fell, inflation expectations became more sticky and the Phillips curve flattened. Against this backdrop, it made sense to adopt a wait-and-see policy to allow time to understand underlying trends.

Today, concerns of a different nature are beginning to surface: a declining participation rate among older cohorts, entailing a decline in labour market slack; quickening productivity linked to digitalisation and the Covid crisis, which could boost potential growth and raise the equilibrium interest rate; rising inflation expectations on the back of price increases, even where these are temporary; and a non-linear Phillips curve that may steepen when unemployment is low.

It would therefore have been appropriate to ask some far-reaching questions. Are these trends established and permanent? Could they be the very trends that will dominate over the coming decades? If so, the cost of a monetary policy too firmly wedded to a wait-and-see philosophy could increase.

These questions are admittedly more relevant to the United States than the eurozone. Nevertheless, the ECB might have been expected to answer one crucial question: are the key trends that have constrained central banks' room for manoeuvre over the past few decades likely to persist over the coming decades (or even just the coming years)?

More specific questions should also have been asked about monetary policy instruments. Besides a comprehensive understanding of the dynamics underpinning inflation, there is also a need to develop a detailed understanding of the relationship between the ECB's actions and its objectives, the effectiveness of monetary policy instruments and the results of the various potential targets and their assorted interpretations.

We think about these questions every day, drawing on the latest academic debate. We had been expecting answers from the Fed's analysis, and the ECB's even more so. We – and with us all those who were looking for solid foundations on which to build their medium-term expectations – were disappointed.

Without this kind of clarification, without guidance on expectations and with the little additional room for manoeuvre the ECB has allowed itself, the weight of the challenge of supporting potential growth and inflation will fall on fiscal policy. And, in this regard, one might legitimately wonder how much room the fiscal authorities will have to achieve these objectives so as to be able to regain some monetary policy leeway. ■

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