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The Two-pillar Strategy of the ECB: Ready for a Review

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies

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The Two-pillar Strategy of the ECB: Ready for a Review

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Abstract

Inflation has remained below the ECB's own target of 'below, but close to 2%' for a long time despite massive doses of unconventional policies, suggesting that the present 'two pillar' strategy does not work. A review of the strategy will be useful only if it is entrusted to independent experts. Otherwise, it is likely to result in the finding that only marginal changes to the existing strategy are needed and that larger doses of the present policy will be sufficient to achieve the inflation target.

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CONTENTS

LIST OF ABBREVIATIONS

ECB	European Central Bank
FED	Federal Reserve Bank
FOMC	Federal Open Market Committee
GC	Governing Council
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
QE	Quantitative Easing
RHS	Right-hand side
US	United States of America
IMF	International Monetary Fund

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EXECUTIVE SUMMARY

The persistence of low inflation despite massive doses of unconventional policy by the ECB suggests that a fundamental review of its strategy is warranted. All aspects of monetary policy strategy, including the definition of price stability, the instruments of monetary policy and communications should be up for review. This contribution cannot deal with all these aspects. It concentrates on two sub-issues: the organisation of the review and the presentation of the strategy in ECB communications.

Within this limited scope, our recommendations about the review of monetary policy of the ECB are the following:

- The ECB still follows officially a 'two-pillar' strategy. However, *de facto,* the pillars have been abandoned since the financial crisis. Over the last decade, the two pillars have been used in a formal way to justify monetary policy decisions. In reality, one finds little trace of the essential elements of the monetary pillar in the speeches of members of the Governing Council.
- We could not find a single instance in which the ECB admitted that the two pillars, i.e. the economic and the monetary analysis gave different signals. This is not credible. In reality, there have been important instances when taking into account the different signals from the two pillars could have led to different decisions.
- The economic pillar has become an *ad hoc* application of basic relationships between interest rates, demand and prices all of which have become rather tenuous or at least contested over the last years. A fundamental appraisal of the current functioning of these economic mechanisms is thus overdue. (However, this will take considerable resources and thus cannot be achieved in this limited contribution).
- The review should be conducted as much as possible by external experts. The 2003 review was conducted by the Governing Council itself and resulted merely in a confirmation of the existing (two-pillar) strategy.
- Elements of the 'Fed Listens' framework might be useful for the review of the ECB's strategy. But, one key element, namely events involving the local public organised by the individual District Federal Reserve Banks might be difficult to replicate. Great care should be taken to ensure that events organised by national central banks do not degenerate into platforms for national points of view. There is no need to institutionalise the review.

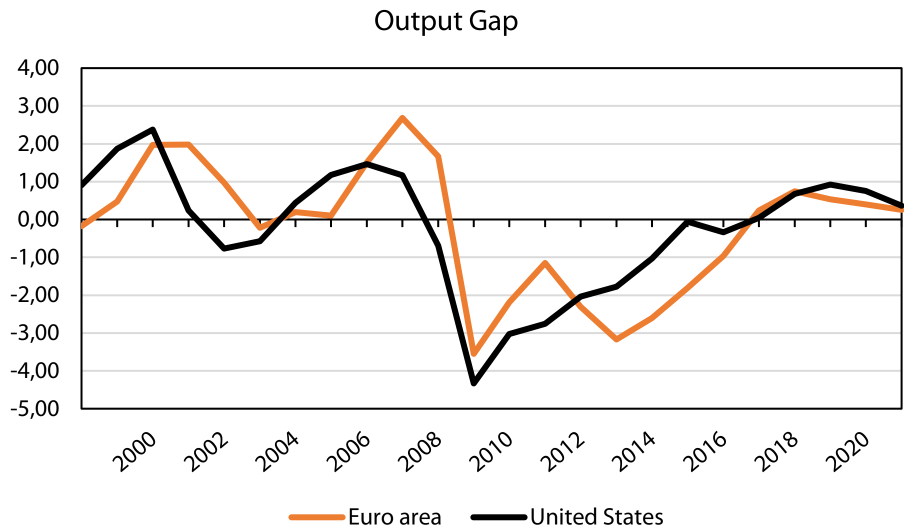
1. BACKGROUND: THE CONUNDRUM FACING THE ECB

The economy of the euro area has by now recovered from the deep double dip recession which followed the financial and euro debt crisis period starting in 2009. Employment is nearing pre-crisis peaks and unemployment has declined continuously over the last 6 years (and is likely to continue its decline according to Commission projections), Figure 1. Another measure of economic slack, namely the output gap, has also returned to its pre-recession average (Figure 2).

Figure 1: Unemployment Rate for Euro Area, percentage, annual, (including forecast for 2019-2021)

Source: AMECO.

Figure 2: Output gaps: deviations of actual GDP from potential GDP as % of potential GDP, for Euro Area and US, percentage, annual (including forecast for 2019-2021)

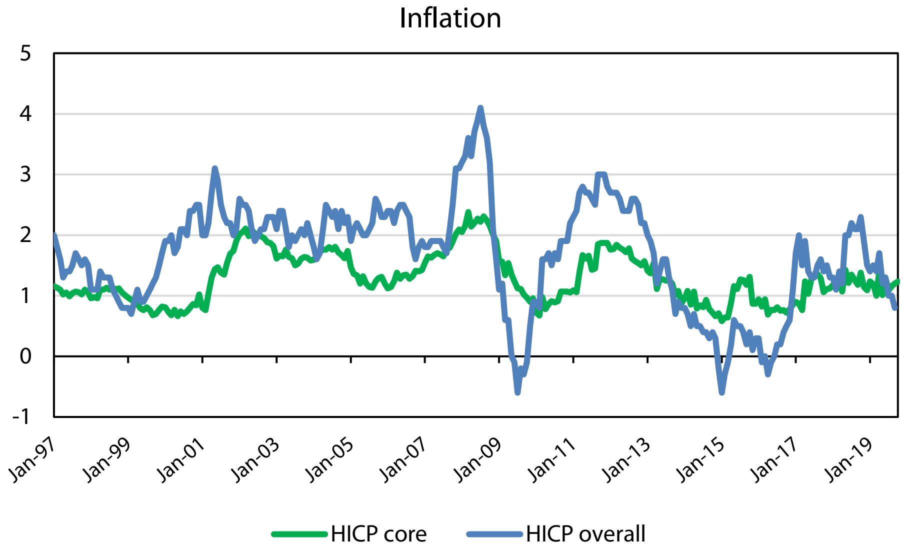


Source: AMECO.

These two activity-based indicators would normally suggest that inflation should now also start to increase. However, this has not happened. As depicted in Figure 3, actual inflation is now declining towards 1 % (and has been rather variable over the last years). More stable core inflation which excludes the volatile components of energy and unprocessed food, has remained close to 1 %, over the last 5-6 years. Moreover, market based indicators of inflation expectations are consistent with an inflation rate close to this level for the foreseeable future (Lane, 2019).

This is the basic conundrum facing the ECB: the real economy is doing reasonably well, at least trend-wise, while inflation remains stubbornly below target. Whether the so-called Phillips curve, which links inflation to unemployment remains a useful relationship is hotly debated in the literature (see Blanchard , 2019 and Lane, 2019 for two different points of view).

Figure 3: Euro area annual rate of Inflation (HICP): Overall Index and Core Index (Excluding energy and Unprocessed Food), annual rate of change, percentage change, monthly



Source: Eurostat.

Persistently low inflation constituted the key reason why, some years ago, the ECB introduced 'non-standard monetary policies' (negative rates and asset purchases). However, inflation has not increased after massive doses of monetary easing (asset purchases and highly negative policy rates). Whether this is a sign that the policy has not worked, or whether the policy has worked, but inflation would have been even lower in its absence, constitutes another unresolved issue (see Summers and Stanstead, 2018; Cochrane, 2018; and further references in Gros, 2019).

The ECB is not alone in not being able to reach its own inflation target. Japan and a number of other countries in Europe (e.g. Switzerland) are in a similar situation as inflation has not increased despite very expansionary policies pursued for a long time. The open issue of the effectiveness of monetary policy at the lower bound is thus not necessarily a problem specific to the euro area.

The US Federal Reserve is in a different situation. Its mandate includes two objectives - price stability and full employment. Secondly, it can claim to have attained both, since the unemployment rate is at a record low and inflation is close to 2 %. The context for the review of monetary policy is thus different for the ECB.

This contribution is organised as follows. Section 2 starts with a description of the ECB's two-pillar strategy and critically analyses how it has been presented in ECB communications. Section 3 presents a brief comparison with the Federal Reserve and other reviews. Section 4 concludes and suggests some preliminary recommendations.

2. THE ECB'S TWO-PILLAR STRATEGY: HAS IT BEEN IMPLEMENTED?

The last formal review and presentation of the monetary policy strategy of the ECB dates back to 2003. This section first presents the key elements of this strategy, which is still presented as valid today. We then present a brief analysis of the external communication of the ECB, which suggests that key elements of this strategy have been put aside.

2.1. The official two-pillar strategy

The website of the ECB provides a clear representation of the present (official) strategy.[1]

In essence, the ECB has defined the term 'price stability' (which the Treaties give as the over-riding objective of monetary policy) as an inflation rate 'below, but close to 2 %', with inflation measured by the increase in the HICP. The ECB assesses risk to price stability through its 'two pillars': economic and monetary analysis.

This section will focus on the second element, namely the 'two-pillar approach'. This approach, with its monetary pillar was widely perceived as relict from the practice of the Bundesbank to announce reference rates for the growth rate of money. The underlying assumption of this emphasis on the growth of money was that the price level could not increase at a great pace if the money supply was limited. This argument might have had some merit when fighting inflation was the main problem (as it was thought to be when the ECB was created). But the emphasis on monetary aggregates is more difficult to justify when the problem is to get inflation up (slightly).

Another reason for focusing on monetary aggregates could be that money and credit growth are usually linked and credit growth can signal a danger to financial stability. This justification was indeed used in 2003 (see box), but the warning signs coming from relatively high rates of money (and credit growth) were largely overlooked during the boom years up to 2007.

[1] See https://www.ecb.europa.eu/mopo/strategy/html/index.en.html.

Box 1: The 2003 'review'

The 2003 strategy of the ECB was extensively described by the new President of the ECB in a major speech in 2003. The key elements were described by Trichet:

"As you know, this is a topic which the Governing Council of the ECB discussed at great length in the first half of 2003, when we conducted an evaluation of our experience with the strategy. This review resulted in the confirmation of our strategy on 8 May 2003."

This paragraph shows that the 2003 review was conducted internally, with the result that the previous practice was confirmed.

A first key element of the strategy was the quantitative definition of price stability, which is still used today:

The May 2003 clarification: "HICP inflation below but close to 2%"

A second key element of the strategy was the so-called two pillar approach which comprises a first pillar (economic analysis) and a second pillar (monetary analysis). Trichet characterised thus:

"The two pillars

A further element of the strategy relates to the analyses and economic perspectives of the risks to price stability, which are founded on a two-pillar framework. The two-pillar approach permits conveying to the public the notion of a diversified analysis and of ensuring robust decision-making based on different analytical perspectives."

The justification for the monetary analysis was the following:

"As regards the analysis under the monetary pillar, the ECB decided from the outset to single out money from the set of selected key indicators that it would monitor and study closely. "

The main innovation of the 2003 review was that the ECB discontinued its annual review of the reference value for (the rate of growth of) M3. But formally the monetary pillar was maintained.

As an aside, we note that one additional justification for the monetary pillar seemed prescient:

"As an important side effect, the regular examination of monetary trends might help to detect financial imbalances. There is often a strong positive correlation between credit growth and rapid rises in asset prices in the run-up to a speculative bubble. The emergence of such long-run disequilibria in the economy has to be taken into account in setting monetary policy. Such fundamental imbalances may cause problems for the economy well beyond typical inflation forecast horizons. I note that this point of view is increasingly also considered by other central banks. Our framework, with its emphasis on monitoring money and credit developments and the sustainability of macroeconomic developments, is in this respect well equipped to take into account the implications of exceptionally strong dynamics in the financial markets in terms of potential risks to price stability over the long run."

Unfortunately, the warning signs from rapid credit growth, which preceded indeed the financial crises, did not have a decisive impact on monetary policy.

Source: ECB (2003), "The ECB's monetary policy strategy", press release, 8 May 2003.

2.2. Two pillars in external communication

One way to gain an initial idea on whether the 'two-pillar' strategy has actually guided monetary policy is to analyse the external communication of the ECB, in particular how decisions were motivated. For this purpose, we conducted a text analysis of two kind of source:

i) The Press Conferences following monetary policy decisions. These press conferences take place roughly every month, with a total of nearly 250 since the start of EMU.

ii) Speeches by members of the Governing Council. Each year members of the Governing Council give dozens of speeches in which they discuss a variety of topics, typically issues pertaining to the policy of the ECB. The collection of these speeches made by the ECB comprises over 2 400 entries since 1997.

All these documents are publicly available on the ECB website.

Using Python, an open source programming language, we used web scraping techniques to retrieve quantitative useful information to understand how the two pillars were used to discuss and justify monetary policy over the last two decades. This text mining technique is becoming increasingly popular in many fields[2], however, it has not been used much for central banking (Bholat et al., 2015). Our results show the usefulness of this analysis to gain some insights into the key issues, which drove monetary policy in the euro area.

In concrete terms, we looked at the frequency[3] of certain key concepts (e.g. inflation, economic analysis, monetary analysis) over time.

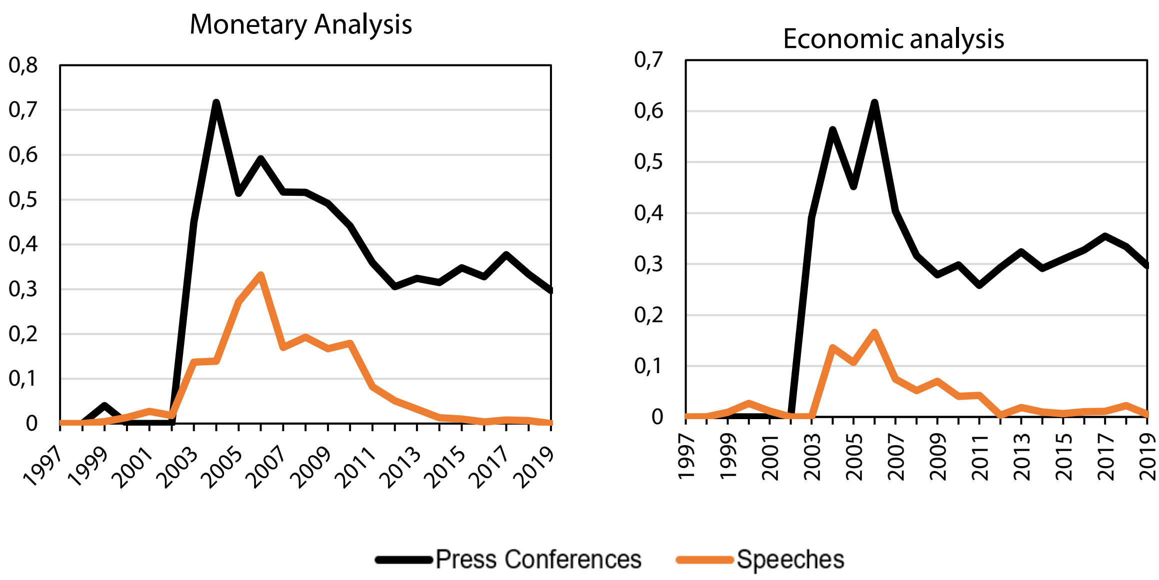
The results of our text analysis is shown in Figure 4 where the black lines refer to the analysis of press conferences and the red line to the speeches by Governing Council members. These results suggest that the 'two-pillar' approach is followed in mainly a *pro forma* fashion. The economic and monetary analysis represent the two pillars. The frequency with which these terms ('monetary analysis' and 'economic analysis') are mentioned shoots up after 2003 (from zero to 0.6 per thousand words). But the frequency then declines to about one half of its peak value for the press conferences and to zero for speeches.

The difference between press conferences and speeches is revealing: when Members of the Governing Council (including the President) present their thoughts without being constrained by the form of a press conference, they mention the two 'pillars' much less (and not at all over the last years). This suggests that the two pillar strategy with its separate 'monetary' and 'economic analysis have played little role in their thinking.

2 See Gentzkow et al.(2018) for an extensive review on the topic.

3 The number of occurrences of each individual concept was then normalised by the total annual amount of words contained in the documents examined (speeches by Governing Council members or Press Conferences after a monetary policy decision).

Figure 4: Words occurrences normalised by total annual number of words and multiplied by one thousand, annual



Note: The plot represents the occurrence over time of two words for the Speeches (orange line) and the Press Conferences (black line) of the ECB. The left panel concerns the word "Monetary Analysis", and the right one the word "Economic Analysis". The sample period goes from 1997 to 2019. The search is case sensitive.

Source: ECB Press Conferences and Speeches, authors' computations.

We also checked separately for the occurrence of the word 'pillar' in speeches and found that this term was used for a few years after 2003, but then disappeared rather quickly.

Another strong indication that the 'two-pillar' approach has been effectively discarded comes from the fact that the 'cross-check' between the two pillars has never uncovered any discrepancy between the economic and monetary analyses. We examined all press conferences since 2009 and did not find any instance in which the economic and the monetary analyses gave very different signals. A separate economic and monetary analysis make sense only if they give, at least from time to time, different signals.

Over the last 5 years, the introductory statement for the press conference following ECB decisions contained a paragraph along these lines:

> *"To sum up, a cross-check of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed/confirms ……* »

With two exceptions (September/October 2015), this statement has been copied and pasted from October 2014 to the present (about 40 times).

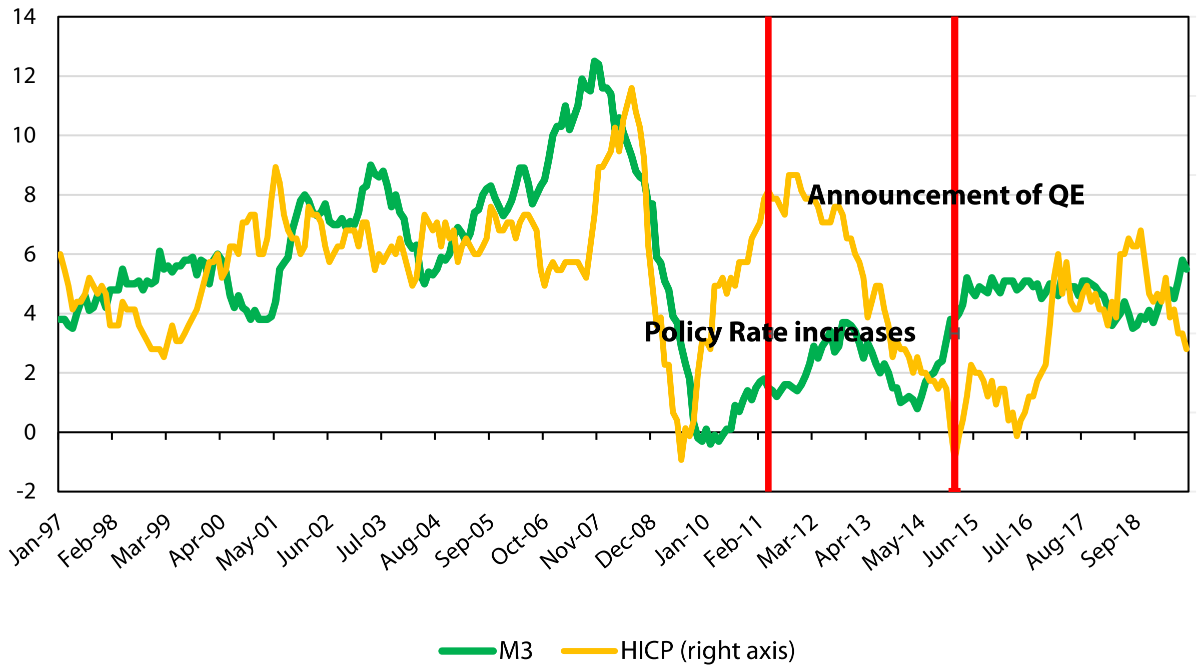
Even before 2014, the paragraph on the cross-check (of the outcome of the economic analysis with the signals coming from the monetary analysis) was always accompanied by the verbs 'confirm', 'support' or similar expressions. According to the ECB there was never any instance of different signals from the economic and the monetary analysis.

In reality, one can of course find a number of episodes when the two pillars gave different signals. To illustrate this Figure 5 shows the (annual) growth rate of M3 (the preferred monetary aggregate of the ECB). Two red vertical lines show two episodes of different signals: for example, in early 2011, the economic analysis suggested increasing inflationary pressures while money growth (M3) stood at only

2 % (and had been falling until a few months beforehand). However, the press statement justifying an increase in rates (2011 April) stated that the monetary analysis also supported a tightening. This increase had to be reversed soon and is generally considered to have been a mistake.

Another important episode came when inflation was low, but M3 was increasing by close to 5 %. In this case, the ECB was aggressively easing (2015Q1). The same can be said about the last (September 2019) decision by the ECB to start an entire package of easing measures although the money supply continues to increase at about 5 %. In these cases, the ECB still maintained that both the economic and the monetary analysis supported its decision because money growth, while satisfactory, could otherwise fall back.

Figure 5: Broad money aggregate (M3), annual growth rate, in percentage and core inflation (right axis), annual rate of change, percentage change, monthly



Note: The green line is the annual growth rate of the euro area Monetary Aggregate M3 in percentage change. The yellow line represents the core HICP Index (HICP excluding energy and unprocessed food), annual rate of change, percentage change, associated with the right axis. The vertical red lines represent two monetary policy decisions: 1) the first one in April 2011 when the ECB increased the policy rate, 2) the second one in January 2015 when the ECB announced the Quantitative Easing. The data frequency is monthly and the sample considered goes from 1997/January to 2019/September.

Source: ECB Statistical Data Warehouse.

3. LEARNING FROM OTHERS' EXPERIENCES

3.1. Transatlantic differences in communication

The Federal Reserve announced one year ago a review of its policy strategy. This review has been implemented starting from the second half of this year, and the results will be made public in 2020. As mentioned above, the context is different from that of the ECB in several respects. First, differently from the ECB, the Federal Reserve has a 'dual mandate' of maximum employment and price stability. Secondly, the starting position of the Federal Reserve's review is that both mandates have been achieved. This is also reflected in the announcement of the Review by the Federal Reserve (see FOMC, 2019).

To analyse differences in the communication, we perform a text analysis of the Fed's Statements, calculating the relative occurrence of certain key words and comparing them with the ECB's Press Conferences, following the same procedure explained in the previous section.

Figure 6 shows the results of this analysis in four panels, referring to four words. From this figure we can draw three main conclusions.

First, given that the Federal Reserve has a dual target, as one would expect, we find a much higher frequency of the word 'employment' for the Fed, as displayed in the fourth panel of Figure 6.

Second, we find rather similar trends, over the last decades, for both the Fed's Statements and the ECB Press Conferences for the frequency of the words 'inflation' and 'price stability'. However, while the former tends to increase over time, the latter decreases on both sides of the Atlantic. It is surprising that both these terms appear more often in Federal Reserve statements than in those of the ECB (the scale of the RHS is different for the ECB)[4], even if the Fed has achieved its inflation target.

Third, one finds that the Federal Reserve mentions 'financial stability' in its motivations for monetary policy decisions only during two years (2009 and 2010). The ECB, by contrast, seems to have been concerned about financial stability even before the crisis, and continues to mention financial stability even after the crisis abated. This points to another inconsistency: as mentioned above, the monetary analysis had been motivated, at least partially, by concerns about financial stability. However, we also showed that one cannot find a single instance in which the signal from the monetary analysis was seen to deviate from the economic analysis. We also could not find a single instance in which concerns about financial stability were used to justify a monetary policy decision.

Despite these crucial differences among the frameworks in which the ECB and the Fed currently operate, it is very important to look at the Fed's experience in terms of reviewing its monetary policy conduct to learn how to implement a potential future ECB's review. However, since the review is still ongoing we could only highlight the broad procedure that has been announced on their website.

One needs to keep in mind the purpose of the Fed's review. The attainment of Fed's objectives shows, in its own view, that the monetary policy strategy has worked well so far, thus the final aim of their review, would be to analyse if the current framework would still be sufficient to face future challenges or if it could be improved.

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[4] For the ECB, the relative frequency is calculated including the questions and answers part of the press conference. The Federal Reserve does not hold such press conference, resulting in a much lower overall length of the material. We performed a robustness test by concentrating for the ECB only on the introductory statement. This gave qualitatively very similar results.

Therefore, the review is announced to have broad-scope, with no prior idea of the possible outcomes. However, there are limits. The review is to look at the best strategies to achieve the existing given inflation target (over the long run). The Federal Reserve is not planning to revise the target itself.

The review should thus focus mainly on how to improve the tools, the communication and the overall strategy of monetary policy. The Fed is seeking external points of view, through the Fed Listens events, where participants have a very broad and varied background (it is not required that they have a deep knowledge of monetary policy). This is crucial for the effectiveness of the review and we believe it would be important to take it as an example for the ECB case.

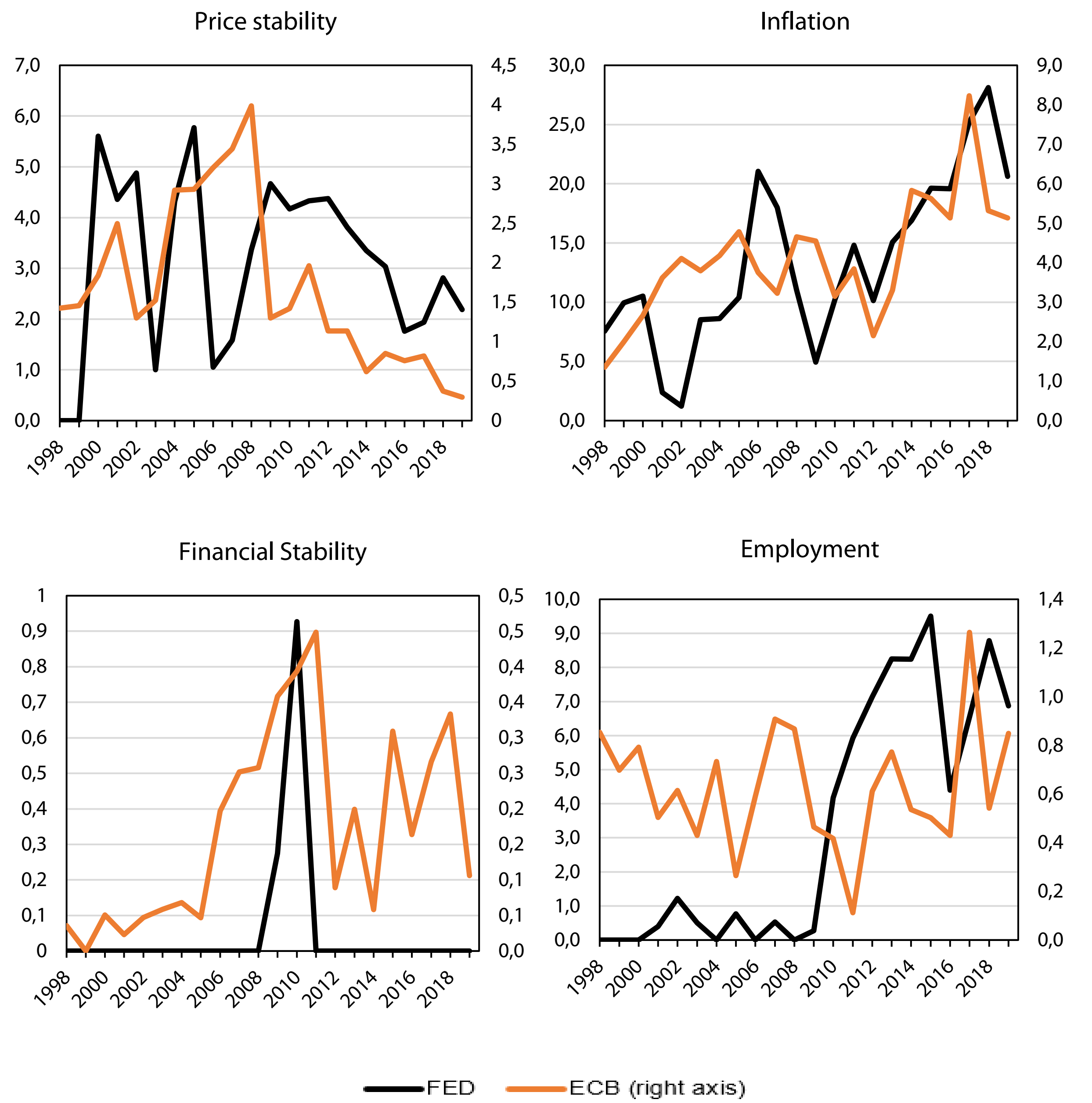
Key elements of the review in the US have been events organised by each individual regional Federal Reserve Bank in which a wide variety of participants, not only academic economists or financial market specialists, were asked to air their views. This approach can work well in a 'political union' like the US where views on monetary policy are not so strongly influenced by national perceptions and preferences as in the euro area. In the US, the concerns of various interest groups and the general public are not as regionally concentrated and differentiated as in Europe.

The outcome would be predicable if each national central bank in the euro area were to hold a separate event. The contributions from academic economists might be varied because they could be invited from all over Europe (or even globally). However, the local public and local interest groups (e.g. banks, but also SMEs, etc.) would have sharply different opinions from country to country. Much care would have to be taken that a 'the ECB listens', for example in Germany, does not degenerate in generalised ECB bashing.

A last important element concerns the fact that, differently from the ECB, the Fed enunciated for the first time its strategy only very recently, in 2012, i.e. after the crisis, by publishing the Statement on Longer-Run Goals and Monetary Policy Strategy. Hence, the ECB would have a much longer time frame to review and it would also have more of a reason to adapt its strategy given that the macroeconomic environment has changed so much.

In the next section, we briefly analyse the reviews that have been undertaken by the Reserve Bank of New Zealand and the IMF. Our aim is to focus on the procedure that have been followed by these two institutions, so that we can learn from their experiences.

Figure 6: Words occurrences: Fed and ECB comparison, normalized by total annual number of words and multiplied by one thousand, annual



Note: The plot represents the occurrence over time of four words for the ECB's Press Conferences (orange line, on the right axis) and the Federal Reserve's Press Statements (black line). The upper left panel concerns the word "Price stability", the bottom left the word "Financial Stability", the upper right "Inflation" and the bottom right "Employment". The sample period goes from 1998 to 2019. The search is case sensitive.

Source: ECB Press Conferences and Fed Statements, Authors' computations.

3.2. Experiences of past reviews

There are only rather few examples of external reviews of policymaking institutions' strategies. The Central (Reserve) Bank of New Zealand and the IMF provide two instructive cases.

Concerning the case of New Zealand, in 2000 the Minister of Finance invited an external expert, a reputed economist specialising in monetary policy, Prof. Lars Svensson, to review the central bank's monetary policy operations. The review was thus performed outside the central bank itself, following a simple procedure. First, the external expert was provided with very precise terms of references, concerning the central bank's monetary policy conduct to achieve its inflation target, its instruments, the information set used by the bank to take decisions, its governance and accountability structure, its coordination with other policies, and finally its communication. Second, the expert personally visited the bank for some time (two weeks) to observe monetary policy operations and collect material and held discussions with other monetary policy experts from different countries. Third, the expert published a final report.

The Reserve Bank and the Minister of Finance, after consultation with parliamentary parties, publicly released their responses to these recommendations.

The advantages of having one expert conducting the entire review were speed and transparency. The drawback is that different experts have often very different opinions about how monetary policy works and what the best strategy might be to achieve price stability. In the early 2000s this disadvantage was not so pronounced as there was much less disagreement than today. However, today's situation when there is sharp disagreement about many basic elements of monetary policy (is there still a link between unemployment and inflation, does unconventional policy work, where is the effective lower bound?) it would seem that a team of independent experts would be needed to encompass the opinions of the profession.

The International Monetary Fund (IMF) is another institution which has undergone a fundamental review. In July 2001, the Executive Board of the Fund established the Independent Evaluation Office (IEO). The goal of this office is to systematically provide evaluations on relevant issues in light of the IMF's mandate, in an objective and independent fashion. Moreover, starting from 2006 periodical external evaluations of the evaluator have been conducted by the Fund's Executive Board to assess its effectiveness and determine if its work should be improved. One key element of the work of the IEO is that it regularly solicits inputs from outside the official community.

The IEO of the IMF is a permanent institution, headed by outside experts, but with a substantial staff of its own. This is of course different from the once-off review which the ECB has in mind. Another difference to the IMF is that the ECB reports regularly to the European Parliament, to which it is accountable. The European Parliament, in turn, has at its disposal a pool of external experts, which can provide its members with a range of opinions on all aspects of monetary policy. It would thus not seem appropriate to create a permanent review body inside the ECB.

4. CONCLUDING REMARKS

The 'two-pillar' strategy of the ECB might have been useful when fighting inflation was the key task. Today the key concerns are financial stability and low inflation. This means that the strategy should be radically rethought. The monetary pillar has been effectively discarded, as shown above. However, the economic pillar also faces problems since it has become an *ad hoc* analysis of economic developments, in which it is generally assumed that higher demand will lead to price pressures. Nevertheless, this has not been the case. Decisions on monetary policy then rely on an assumed link between instruments and inflation (the desired outcome); a link which involves a number of intermediate steps.

1. Monetary policy instruments, whether conventional or not, aim to affect 'economically relevant' interest rates (and, more in general, financial conditions throughout the economy). E.g. lowering policy rates should lower the refinancing costs of banks, which should then result in lower rates on loans.
2. Lower interest rates, or more generous financial conditions, should then foster increases in expenditure (mainly investment and consumption, but possibly also in exports via a lower exchange rate).
3. This increase in demand should lead to higher employment.
4. Higher employment (or lower unemployment, lower slack in general) should then lead to higher wages and finally higher prices.

All the links in this chain of mechanisms deserve close scrutiny because they do not seem to work as intended.

Any review of the monetary policy strategy of the ECB will thus have to put into doubt many fundamental issues and might thus implicitly criticise present policies. This is unlikely to be allowed in an internal process. Reviews of the last 20 years by high ranking ECB staff tend to conclude that the strategy of the ECB is entirely appropriate (e.g. Hartmann and Smets 2019). It is thus important to have an external review.

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QUESTIONS FOR MEPS

1) Should inflation and price stability be measured using a different price index; for example, wages, the GDP deflator and, possibly asset price inflation?
2) The ECB aims at inflation 'below, but close to 2 %'. Such a narrow target is difficult to reach when inflation reacts so sluggishly to monetary policy measures. Should the target range be widened?
3) Ever more negative rates, or further asset purchases might, according to many experts, now be counter-productive. Should the ECB consider just leaving its very expansionary stance where it is, even if inflation remains below target?

Inflation has remained below the ECB's own target of 'below, but close to 2%' for a long time despite massive doses of unconventional policies, suggesting that the present 'two pillar' strategy does not work. A review of the strategy will be useful only if it is entrusted to independent experts. Otherwise, it is likely to result in the finding that only marginal changes to the existing strategy are needed and that larger doses of the present policy will be sufficient to achieve the inflation target.

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