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Should the ECB be tightening faster?

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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Monetary Dialogue Papers
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Abstract

This paper discusses how the ECB should respond to the current high inflation rate. Rather than implementing a large upfront tightening, a steady and gradual adjustment of policy is recommended, particularly considering the evidence that the global economy may be heading towards recession.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the Committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 26 September 2022.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
ECB	European Central Bank
HICP	Harmonised index of consumer prices
MRO	Main refinancing operation

LIST OF FIGURES

EXECUTIVE SUMMARY

- **HICP inflation is currently about 9%, far above the ECB's preferred inflation rate of 2%.** This paper discusses how the ECB should respond to the current high inflation.
- **The rise in euro area inflation this year is largely due to the impact on food and energy prices of the war in Ukraine.** Much of the rise in core inflation also reflects rising input costs due to higher energy prices. Arguments that ECB policy over the last year are an important contributing factor to the current high inflation are largely incorrect.
- **Conventional macroeconomic thinking can be used to argue that current inflation and unemployment rates call for very high monetary policy interest rates.** The paper shows how a "Taylor rule" formula would point to interest rates as high as 12% but explains why this kind of rule over-states the level of interest rates likely needed to reduce inflation.
- **While policy rates should be increased, there are various reasons why they should be adjusted gradually rather than raised quickly to higher levels.** These include the uncertainty of the economic situation and the desire to maintain financial stability.
- **In deciding the speed at which interest rates should be increased, a number of factors should be considered.** These include whether the increase in inflation is leading the public to have higher expectations of future inflation and how developments in food and energy markets and the global economy will affect inflation.
- **Some measures of inflation expectations have increased this year.** This isn't surprising in light of the high inflation rate. However, increases in consumer surveys have been modest and financial market indicators of long-run expected inflation are also relatively stable.
- **There are a number of signs that the euro area and world economy are heading for recession.** This will reduce inflation.
- **Also, even if food and energy prices do not drop from their current high levels, these factors will also stop contributing to high inflation by next year.** Even without a monetary tightening, inflation in the euro area may fall by a lot in 2023.
- **Rather than implementing a large upfront tightening, a steady and gradual adjustment of policy is recommended, particularly considering the evidence that the global economy may be heading towards recession.**

1. INTRODUCTION

For the third time in its relatively short history, the European Central Bank (ECB) is facing a severe set of macroeconomic challenges. One difference, however, relative to the global financial crisis of 2008 or the euro crisis of 2010-12 is that the current situation represents a more substantial threat to the ECB's ability to deliver on its primary objective of price stability.

Harmonised index of consumer prices (HICP) inflation for the euro area is estimated to have been 9.1% in August (see Figure 1). The ECB's actions in previous crises meant periods of sustained deflation were avoided, so while inflation undershot the ECB's preferred inflation rate of 2%, the size of these shortfalls was limited to under 2 percentage points. In contrast, inflation is now running 7 percentage points above the ECB's target rate. Indeed, as seen in Figure 2, recent high inflation has completely reversed the previous cumulative undershooting of the price level relative to a trend increase of 2% per year going back to the foundation of the ECB in 1999. Despite these developments, the ECB has so far been more cautious than other central banks such as the Federal Reserve and the Bank of England in adjusting its monetary stance, leaving it open to criticisms that it has been too slow to act.

At this point, the ECB is in a very difficult position. Its current monetary policy stance is clearly inappropriate given the high rate of inflation. There is a clear risk of a prolonged period of failing to meet its primary objective of price stability, which may damage the ECB's reputation and credibility and make monetary policy formulation more difficult in the future.

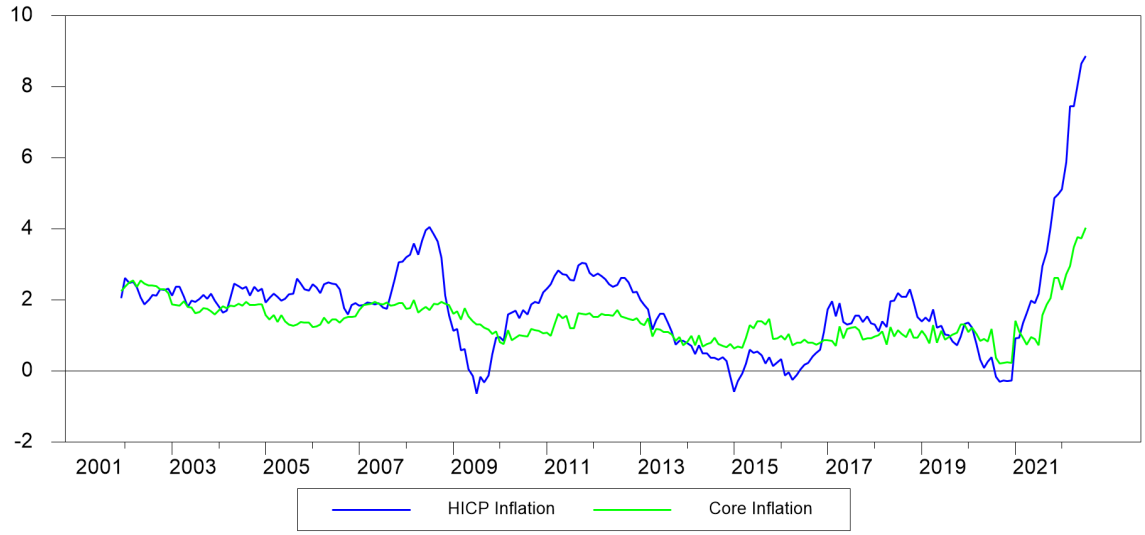
However, while the current inflation rate is clearly unacceptable, when deciding its policy strategy to restore price stability, the ECB needs to consider not only the existing data on inflation which is, by its nature, backward-looking but also to anticipate what is likely to happen with the euro area economy in the coming months. Recent data point to the euro area heading for recession. High energy prices this winter are going to weigh on non-energy consumer spending and business investment and disruptions to production from potential power blackouts will also damage the economy. A severe tightening of monetary policy could see the ECB exacerbating a recession just as stabilising energy prices and falling demand are already causing inflation to fall back to target levels. This approach could be damaging to the economy and a reversal of the policy tightening could also be damaging to the ECB's reputation.

Given the complexities of the current situation, it is understandable that there are disagreements within the ECB Governing Council members about how to proceed in the coming months. Some Governing Council members clearly favour larger interest rate increases in the coming months than had previously been expected. For example, at the recent Jackson Hole conference, ECB Executive Board member Isabel Schnabel (2022) laid out a case for being highly concerned about inflation remaining elevated for a long time. Schnabel pointed to the risk that inflation expectations could become "de-anchored" and the possibility that the Phillips curve relationship between inflation and unemployment had become "flatter", suggesting tighter policy and higher unemployment rates may be required to reduce inflation relative to previous periods where inflation declined. In contrast, in another recent speech, Executive Board member Philip Lane (2022) argued for a "*multi-step calibrated series rather than a smaller number of larger rate increases*", a so-called "meeting by meeting" approach.

The remainder of this paper will discuss the current situation and the options for ECB monetary policy as follows. Section 2 reviews how euro area inflation rose over the past year and whether the ECB has made mistakes in its monetary policy over this period. Section 3 discusses the arguments for jumping straight away to a much higher policy rate and the counterarguments that any increases in policy rates should be small and gradual rather than swift. Section 4 discusses the upside risks to inflation noted by

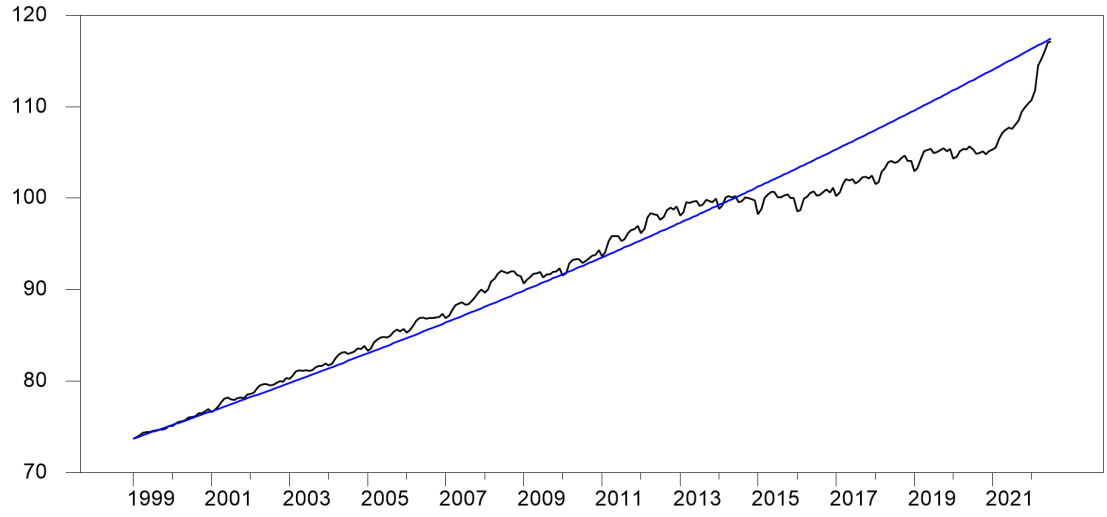
Schnabel (2022). I argue that evidence of de-anchoring of inflation expectations is limited so far, that secondary effects via wage bargaining have been weaker than might have been expected and that the looming recession is going to weigh on price pressures in 2023. Section 5 discusses communications issues relating to the peak interest rate the ECB expects to reach in this cycle.

Figure 1: Year-over-year total and core HICP inflation for the euro area



Source: Author's calculations based on data from Eurostat. Core inflation excludes energy, food, alcohol and tobacco.

Figure 2: The HICP level compared with a 2 percent inflationary trend since 1999



Source: Author's calculations based on data from Eurostat.

2. HOW DID WE GET HERE?

Macroeconomic policy plays an important role in determining inflation and it has certainly influenced the current high rates of inflation around the world. Ex post, one can see that the policies of central banks around to world to respond to the COVID pandemic with substantial monetary stimulus combined with fiscal stimulus to produce an excess of demand over supply once the economic effects of the pandemic began to recede. This doesn't mean these policies were mistaken. The pandemic involved potential "tail risks" of a prolonged global depression and deflation. A forceful macroeconomic policy response was appropriate, with the correct approach being to deal with any subsequent inflation by tightening policy.

In relation to the current surge in euro area inflation, I believe it would be unfair to assign too much blame to ECB policy over the past year. When I look back on my own opinions on macroeconomic events over the past year, I think my analysis probably broadly matched the opinions of the ECB Governing Council, so any criticism I could level would be based on hindsight.

In my September 2021 briefing paper (Whelan, 2021a), I noted that the rise in HICP inflation (to 3% in August 2021) largely reflected a temporary normalisation of food and energy prices, reversing the declines that had occurred at the start of the pandemic. I contrasted the euro area with the US in that the US had implemented a very large fiscal stimulus and so much of its inflation was being driven by excess demand, while this seemed not to be the case in Europe. I noted that euro area core inflation remained at 1.6% in August and optimistically argued that the period of slightly higher inflation could help to re-anchor inflation expectations back at the ECB's target 2% rate, after years of falling short of this target.

By November 2021, when I provided a briefing on inflation to an Irish parliamentary committee (Whelan, 2021b) I was more concerned. I pointed to some momentum in core inflation and, ironically, warned about Russia's willingness to supply gas to Europe as a potential risk factor. By January of this year, in my briefing paper on inflation expectations, I was worried (Whelan, 2022). Both actual and core inflation rates were increasing and I warned that little comfort could be taken from measures of inflation expectations staying low because they were unlikely to remain so if inflation kept coming in high.

I suspect this escalation in concern was roughly mirrored by most Governing Council members. Nevertheless, the ECB's position in January that the high inflation associated with post-pandemic disruptions and excess demand would fade over 2022 was a reasonable one. Russia's invasion of Ukraine changed the outlook completely. While the war has had a global economic impact on energy and food prices, Europe's dependence on Russian gas means the impact on European prices has been particularly large. Euro area energy prices, which ECB had hoped would fall from their high level in January, have surged upwards another 20% since January (see Figure 3) and food price inflation is now running at over 10%.

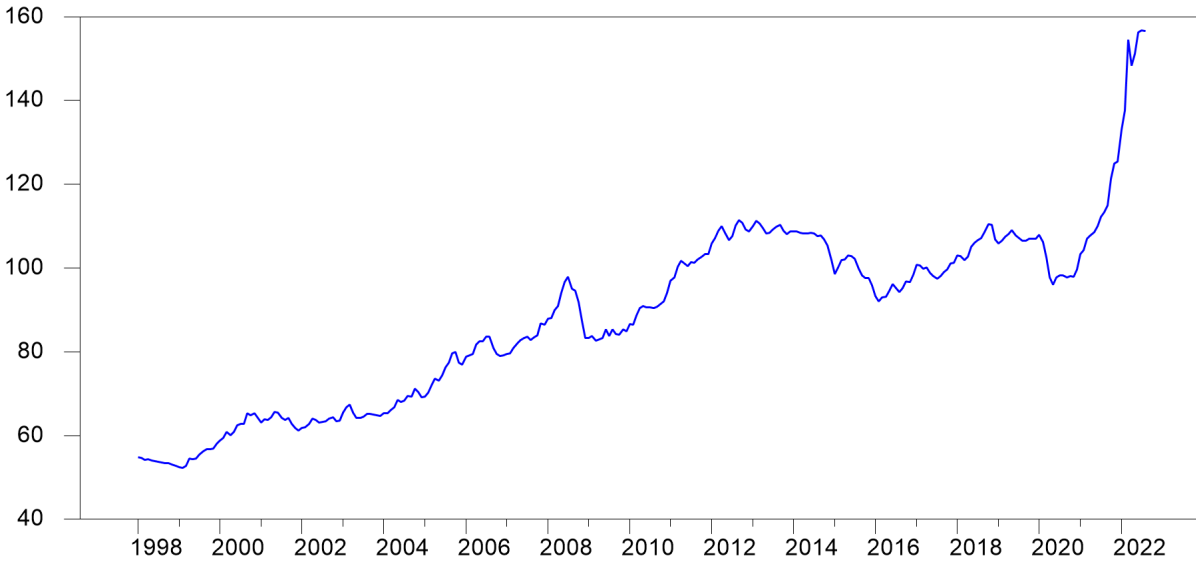
Despite the size of the impact of the war on euro area inflation, the ECB has been slower to react to rising inflation than other major central banks (see Figure 4, which includes the main refinancing rate (MRO) as its measure of the ECB's policy rate). One reason for that is the ECB was starting from a different place in terms of its monetary policy stance. In addition to having a zero MRO rate and a negative deposit rate, the ECB was still engaging in large-scale asset purchases when the war began. Thus, it was always likely that the ECB would implement a monetary policy tightening by first cutting the size of these purchases, then ending net purchases and then raising interest rates.

Some have argued that the ECB should perhaps not tighten policy in response to the supply shocks triggered by the war. The source of the current inflation is not a surge in aggregate demand and the ECB can do little to reduce energy prices, so it could be argued that it should just allow the shock to produce a temporary rise in inflation. It is not clear that this is a good argument in general but for the specific case of the ECB, it is a particularly bad argument.

The ECB's primary objective is maintaining price stability, not "maintaining price stability apart from times when supply shocks raise prices". It is true that, in the past, the ECB could view shocks to food and energy prices as temporary shocks to the level of prices, so that higher-than-target inflation would later be offset by lower-than-target inflation. Figure 1 illustrates that core HICP inflation has indeed been much less volatile than overall inflation. Some central banks, such as the Federal Reserve, have been explicit that they view core inflation as perhaps their key indicator of underlying inflationary trends. However, the current surge in energy and food prices is unlikely to be reversed anytime soon, so there is no reason to expect the effects of the war-related shocks on inflation will even out over time. In addition, energy is a hugely important input into so many goods and services which means core inflation is now also rising, reaching 4.3% in August.

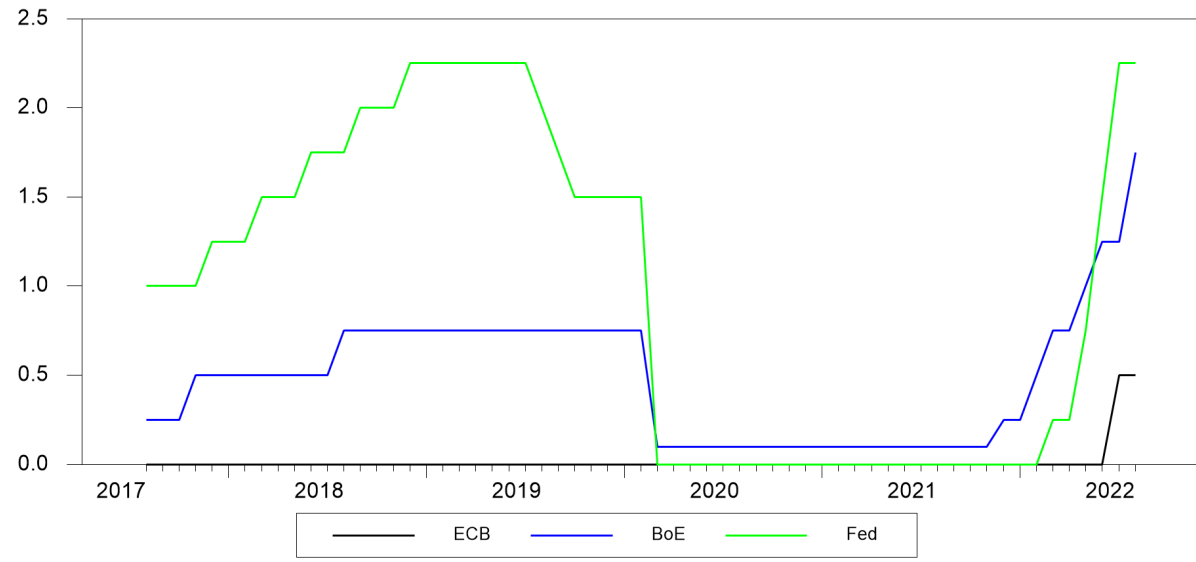
These considerations mean the ECB needs to act. It is possible that inflation may fall back to target even without policy tightening from the ECB. Indeed, I argue below that there are strong disinflationary forces on the way. But given the ECB's need to maintain the credibility of its commitment to price stability as its primary objective, this scenario is not certain enough for the ECB to decide to rely on it. And while the ECB cannot directly affect energy prices, it can use monetary policy to cool aggregate demand, tighten financial conditions and restrain asset prices.

Figure 3: HICP index for energy prices



Source: Eurostat.

Figure 4: Monetary policy rates for the ECB, Federal Reserve and Bank of England



Source: ECB Statistical Data Warehouse, Bank of England, St. Louis Fed FRED database.

3. DRASTIC ACTION VERSUS GRADUALISM

How high should the ECB set rates in response to the current inflation? I want to acknowledge here that a lot of relatively mainstream macroeconomic thinking would call for much higher policy rates than the ECB or financial markets are now considering.

A common benchmark for how to set monetary policy interest rates is the "Taylor rule", named after John Taylor's famous 1993 paper. Taylor proposed a rule to set interest rates with reference to three factors: (i) How far inflation is from its target rate, (ii) How far the economy is from its non-inflationary trend, and (iii) The "neutral interest rate" that would stabilise inflation. In Figure 5, I have compared the ECB's MRO rate with an example of a Taylor for ECB interest rates calculated as follows.

$$\text{Policy Rate} = \text{Neutral Interest Rate} + 1.5*(\text{Inflation Rate Minus } 2\%) + 0.5*(\text{Unemployment Rate Minus } 6\%)$$

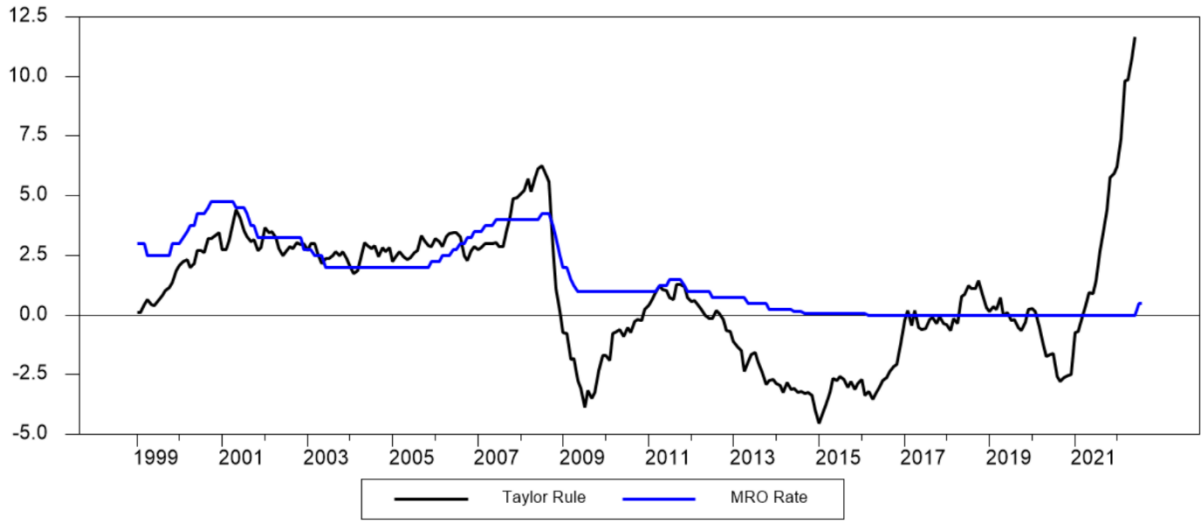
The coefficients on 1.5 and 0.5 here match Taylor's original paper. This formulation treats 6% unemployment as the "natural rate" for the euro area. In relation to the neutral interest rate, there is widespread agreement that this rate has declined since the global financial crisis, so I set this equal to 4% prior to September 2008 and 2% afterwards.

The figure shows during its first decade, the ECB's policy rate matched the recommendations of this rule quite well. During the years after the global financial crisis, the rule often recommended highly negative rates, which cannot be implemented easily in practice, though the ECB did end up setting a slightly negative deposit rate. As of now, even with the assumption of a low neutral rate, this Taylor rule prescribes that the current high inflation and low unemployment call for policy interest rate of almost 12%.

The logic of this recommendation is relatively simple. Taylor recommended that when inflation went up, central banks should raise their interest rates by a greater amount: This is why the coefficient on the deviation of inflation from its target was 1.5 in Taylor's formula. Economic theory predicts that real interest rates (i.e. interest rates adjusted for inflation) are what matters for the economy. For example, suppose the interest rate for a savings account is 5%. If inflation is 8%, then someone who saves money in that account will not benefit from having saved: After a year, their savings will purchase 3% fewer goods and services than could have been obtained from spending the money today.

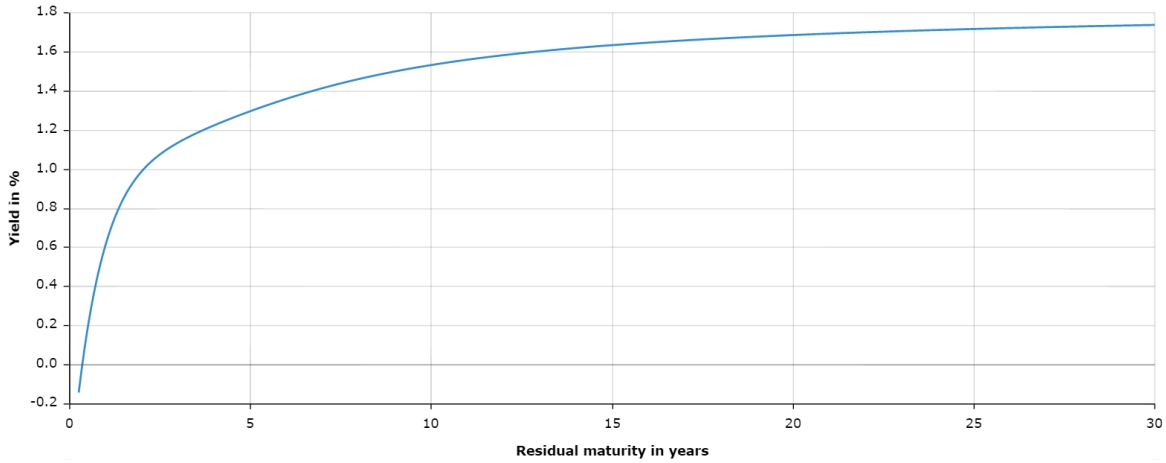
The academic literature on monetary policy rules, such as Clarida, Gali and Gertler (2000), has stressed that following the so-called "Taylor principle"—ensuring that real interest rates rise as inflation goes up—is important for maintaining macroeconomic stability. They and others argued that it was the failure to respect this principle that led to the macroeconomic instabilities of the 1970s.

Figure 5: The ECB's main refinancing operation (MRO) rate compared with a Taylor rule



Source: Author's calculations based on data from Eurostat.

Figure 6: The euro area yield curve for AAA-rated bonds



Source: ECB.

So should the ECB dramatically raise rates, as suggested by this formula? I don't think they should and nobody expects them to. Figure 6 shows the current euro area yield curve. It suggests markets see a modest increase in interest rates over the next couple of years with average interest rates settling down at about 1.8%.

There are a couple of reasons why the Taylor rule is likely sending the wrong signal for policy at the moment.

First, the real interest rate under consideration in the Taylor rule is not the one that matters for the economy. In this case, we are calculating the real interest rate the as the MRO rate minus inflation measured as the percentage change in the HICP over the preceding year. Neither of the elements of this calculation are the best ways to measure the real interest rates that influence the economy. Very few people borrow at the MRO rate. What matters more for the economy are the rates that people expect to pay when paying back debts over long periods of time. So long-term government bond yields and long-term mortgage rates are far more important than the MRO rate. And the correct theoretical inflation rate is not what has happened over the past year but the average inflation rate expected over the term of a contract. Given the behaviour of yield curve and the various ways to measure long-term inflation expectations (discussed more below), there is little evidence that people believe we are entering an era of deeply negative real interest rates that will fuel a boom.

Second, while modern central banks have often cut interest rates by large amounts in response to crises, they tend not to make large adjustments when implementing monetary policy to achieve their normal macroeconomic stabilisation goals of low inflation and stable output. There is a large research literature on the tendency of central banks to smooth out their adjustment paths for interest rates. Some of this smooth adjustment may reflect the underlying variables that affect policy also changing gradually over time but the evidence points to central banks having a preference for adjusting rates in a smooth fashion, independent of the underlying macroeconomic situation.[1]

There are various reasons why a central bank may choose to change interest rates gradually over time.[2] One is that uncertainty about the right policy tends to recommend smaller and gradual movements overly sharp large changes, a theme stressed in the academic literature by Brainard (1967) and Sack (1998). Central bankers are also concerned about the consequences of sudden changes in policy for financial stability. For example, many participants in financial markets in recent years have taken positions based on the assumption that interest rates will remain low for a long time. A gradual adjustment of interest rates gives participants time to adjust positions and to cope with the re-pricing of assets implied by higher rates. Also, as noted above, long-term interest rates have a key influence on the economy and a strategy of gradually adjusting rates in a clear signalled manner will reduce the volatility in these rates.

[1] Coibion and Gorodnichenko (2012).

[2] Bernanke (2004) provides a succinct summary.

4. UPSIDE AND DOWNSIDE RISKS FOR INFLATION

It is likely that all members of the Governing Council agree that the current monetary policy stance is too accommodative and that interest rates need to be increased. It is also likely that all members agree that a gradual approach should be taken. However, the difficult question is how fast this gradual approach should be. Should the ECB implement a series of small interest rate increases such as 25 basis points at each meeting? Or should they implement larger increases over the next few months, jumping closer to the level they expect to be the peak of this cycle? Which approach is appropriate likely depends on the assessment of upside or downside risks to inflation in the absence of ECB tightening.

In her recent Jackson Hole speech, ECB Executive Board member Isabel Schnabel laid out a number of concerning factors that pointed towards a "forceful policy response". Schnabel's case was well argued and contains a number of important points but in relation to two of her arguments, my assessment is more optimistic about the probability that a slower, more moderated tightening would be more appropriate.

4.1. Inflation expectations

Schnabel expressed concern about inflation expectations rising, leading to a "de-anchoring" which could then affect wage bargaining and price setting for the next few years. She noted that the median expected inflation rate three years from now reported by participants in the ECB's Survey of Consumer Expectations had risen to 3% after being steady at 2% in the survey's early years (see Figure 7).

While it would be preferable for these medium-term expectations to remain equal to the target inflation rate, I think this is actually a small increase given how high actual inflation has gone. Schnabel noted that the mean for expected inflation in three years had risen to close to 5% but the mean in these surveys is always high due to many participants expected unrealistically high rates of inflation. The recent values for this series are close to the values seen when the survey was launched in early 2020 (see Figure 7). Indeed, despite the rise in inflation throughout the year, survey participants continue to expect a significant step-down in inflation next year (see Figure 8). Given my prediction in January that continued high inflation this year would lead to a jump upwards in inflation expectations, the outcomes so far have been quite modest.

Financial markets also do not believe the ECB is going to lose control of inflation over the next decade, as can be seen from the low long-term interest rates illustrated in Figure 6. Breakeven inflation rates for inflation-indexed bonds have increased but not in a way that signals a failure to reach the 2% target in the future: The current breakeven inflation rate on the 10-year French government indexed bond is 2.5%. Since inflation is now well above 2%, this suggests a return to rates of inflation close to 2% over the rest of the coming decade.[3]

The other concern related to inflation expectations is that higher inflation fuels wage inflation which in turn keeps price inflation high. However, as President Lagarde admitted in her most recent press conference that wage growth "*remains contained overall*."[4]

This muted response of inflation expectations from surveys and financial markets suggests the ECB is retaining a significant amount of credibility and that people largely understand the current spurt in inflation as being a temporary phenomenon.

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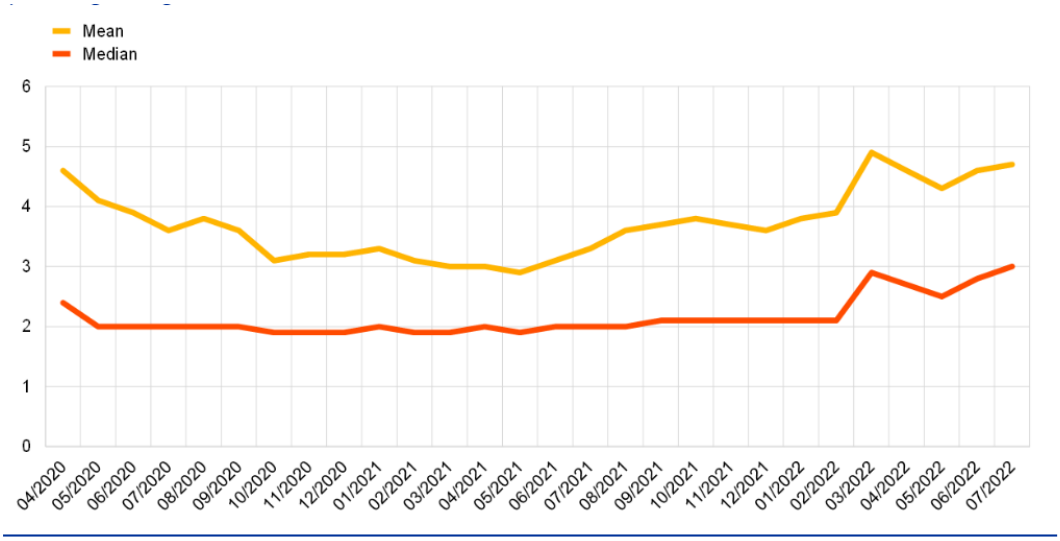
[3] Data available from https://www.aft.gouv.fr/en/oatis-key-figures

[4] See Lagarde, C., Monetary Policy Statement, press conference, 21 July 2022. https://www.ecb.europa.eu/press/pressconf/2022/html/ecb.is220721~51ef267c68.en.html

Schnabel's speech also noted uncertainty about the persistence of inflation as a risk factor, arguing it is better to over-estimate persistence than to under-estimate it and then experience a longer period of high inflation. I'm not sure this really is a separate risk to the risk of inflation expectations becoming de-anchored because the principal source of persistence in inflation is the public's inflation expectations following the realised values.

Figure 7: Expected inflation three years from now from the ECB's Consumer Expectations Survey



Source: ECB.

Figure 8: Recent data on inflation expectations from the ECB's Consumer Expectations Survey

Variable		May 2022	June 2022	July 2022
Inflation perceptions over the previous 12 months	Mean	8.2	8.6	9.5
Inflation perceptions over the previous 12 months	Median	6.6	7.2	7.9
Inflation expectations 12 months ahead	Mean	6.3	6.6	7.1
Inflation expectations 12 months ahead	Median	4.9	5	5
Inflation expectations three years ahead	Mean	4.3	4.6	4.7

Source: ECB.

4.2. Sacrifice ratios and global conditions

Schnabel's Jackson Hole speech also argued that it may require higher interest rates and higher unemployment to reduce inflation than it did in the past, i.e. that the so-called "sacrifice ratio" has increased. I will highlight three of these arguments.

First, Schnabel noted that firms with business models based on intangible capital are less likely to rely on external debt finance and the growing importance of these firms in the economy may make it less

sensitive to changes in interest rates.[5] However, it is not clear that one can link the first claim (intangible firms being less reliant on debt finance) with the second (lower economy-wide insensitivity). While they do not carry as much debt, intangible-based firms rely more on equity finance and higher interest rates reduce share prices and thus discourage investment financed by venture capital or share issuance. And despite the rise of firms reliant on intangible capital and some increase in the share of non-bank funding in recent years, data from the ECB's sectoral accounts show that euro area nonfinancial corporate businesses remain far more reliant on banks for external funding than their US counterparts. An increase in the cost of bank loans will have a negative impact on this sector.

There may also be countervailing factors that have perhaps made modern economies more sensitive to interest rates. The widespread "financialisation" of modern economies has meant that households have built up very large holdings of financial and non-financial assets whose prices are sensitive to interest rates. Governments are also carrying a lot more debt than in previous years, making fiscal positions more sensitive to changes in sovereign yields.

Second, Schnabel notes that the Phillips curve relationship between inflation and unemployment seemed to weaken in recent decades, i.e. that the Phillips curve became "flatter". If this was the case, then it may take a larger increase in unemployment than in the past to generate a decline in inflation.

I am not convinced that the underlying structural determinants of inflation completely changed in recent decades. I wrote about this in a recent paper (Whelan, 2021c) written prior to the pickup in inflation. In that paper, I argued that while Phillips curve relationships were too simplistic to summarise the determinants of inflation, its underlying determinants had probably not changed. I wrote "*There is a strong body of empirical evidence telling us that macroeconomic policy can influence aggregate demand and there is little reason to doubt that stimulating aggregate demand sufficiently can raise inflation.*" The low inflation of recent years occurred because aggregate demand consistently fell short of aggregate supply and the high inflation we are currently experiencing is occurring because the opposite pattern is in place.

Third, Schnabel noted that one of the factors undermining the Phillips curve relationship is that globalisation has meant that the correct measure of economic "slack" that influences inflation is the spare capacity in the global economy rather than national or regional measures. She argues that this means the ECB will need to cool the euro area economy by more than in the past to get a reduction in inflation because it has less influence on global aggregate demand.

The argument that global factors now have a large influence on inflation is certainly correct but, looking forward, there are several reasons to fear that the global economy is heading for recession and that this will lead to a fall in inflation.

High energy and food prices are particularly damaging for less developed countries where essential goods and services represent a largely fraction of household consumption. A slowdown and possible recession is underway in China due to a collapsing property market and restrictions due to the zero-COVID policy. Most importantly, Chinese imports—which have fuelled global aggregate demand for a long time—have flattened out. The US economy still appears to be in robust condition but the Federal Reserve is likely to continue tightening as long as inflation is high and this may also tip the US into recession next year.

Finally, there is the possibility that the euro area is already heading towards recession. Euro area Purchasing Managers Indices have also weakened in recent months to levels that have previously

[5] Schnabel cited theoretical and empirical research by Caggese and Pérez-Orived (2022) and Robin Döttling, Lev Ratnovski (2020) to support this position.

signalled recession. As noted above, high energy prices will weigh on household and business spending in the euro area in the coming months. The possibility of power blackouts could also directly reduce output. Indeed, many firms are now claiming they will have to stop operating rather than remain open with sky-high energy costs. One possibility is that we will see a return of furlough schemes where the state helps firms that are fully or partially shut down to pay their workers.

Even if energy and food prices did not come down from their current historical highs, the impact of food and energy prices on inflation would start to fade by early next year when calculating year-over-year inflation. Even without an ECB tightening, this could combine with a global recession to produce a big fall in inflation next year.

5. COMMUNICATIONS WHILE TIGHTENING

The arguments just put forward mean I agree with ECB chief economist Philip Lane's argument that rather than implement a small number of big interest rate increases in the coming months, the Governing Council should adopt a "*meeting-by-meeting*" approach in which policy is tightened via "*a multi-step calibrated series rather than a smaller number of larger rate increases*." This approach would allow the ECB to continue the required tightening that the current circumstances call for while allowing them to continue assessing whether global conditions are going to reduce inflation faster than is currently expected.

One aspect of Lane's speech that I am less sure about is his recommended communications strategy. The speech argues that the ECB should set interest rate policy by deciding at each meeting on the "terminal rate" that they expect, meaning the peak interest rate they will reach before keeping rates steady or cutting them again. Once this terminal rate is decided, they can then decide on the speed at which they will gradually get to that terminal rate.

The terminal rate plays an important role in Lane's speech: It is mentioned 21 times. However, Lane does not recommend that the ECB tell the public about its expected terminal rate after each meeting. He states:

> "*it is debatable whether more quantitative signalling of the meeting-by-meeting assessment of the prevailing terminal rate is necessary or helpful …. While, in principle, communicating the most likely path for future rate hikes could be an effective monetary policy tool, the potential downside is that it adds to the complexity of communications, especially if there are material revisions to the expected policy path from one meeting to the next.*"

I'm inclined to disagree with this position. Relative to many of the issues the ECB has been communicating about in recent years (its forward guidance on ending the negative interest rate policy, its announcements about the sequencing of its asset purchase programmes, its various policies to counter financial fragmentation) communicating the peak interest rate the ECB expect to reach is a relatively simple matter that most people can understand.

One possible reason for not communicating about the terminal rate could be that Governing Council members would disagree about the correct figure. In this case, the Governing Council could follow the Federal Reserve and release regular surveys in which Council members provide their own forecasts for economic variables and policy rates. The evolving beliefs of the Federal Open Market Committee about the "long run" interest rate that it expects have been communicated efficiently over the past decade through this method. In some cases, the survey has revealed some disagreement among the committee members but this has not detracted from its usefulness in indicating the likely long-run path for interest rates.

In the absence of specific guidance, markets will in any case make their judgements on how far ECB are going to go. But if the Governing Council thinks, for example, that markets have under-estimated the terminal rate and financial conditions should be tightening faster, why not just announce what they think that rate will be? A clear and steady path towards and a signalled destination seems like the best approach to restore price stability without too much volatility along the way.

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This paper discusses how the ECB should respond to the current high inflation rate. Rather than implementing a large upfront tightening, a steady and gradual adjustment of policy is recommended, particularly considering the evidence that the global economy may be heading towards recession.

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