

The New Euro Area Inflation Indicator and Target: The Right Reset?

Zsolt Darvas and Catarina Martins

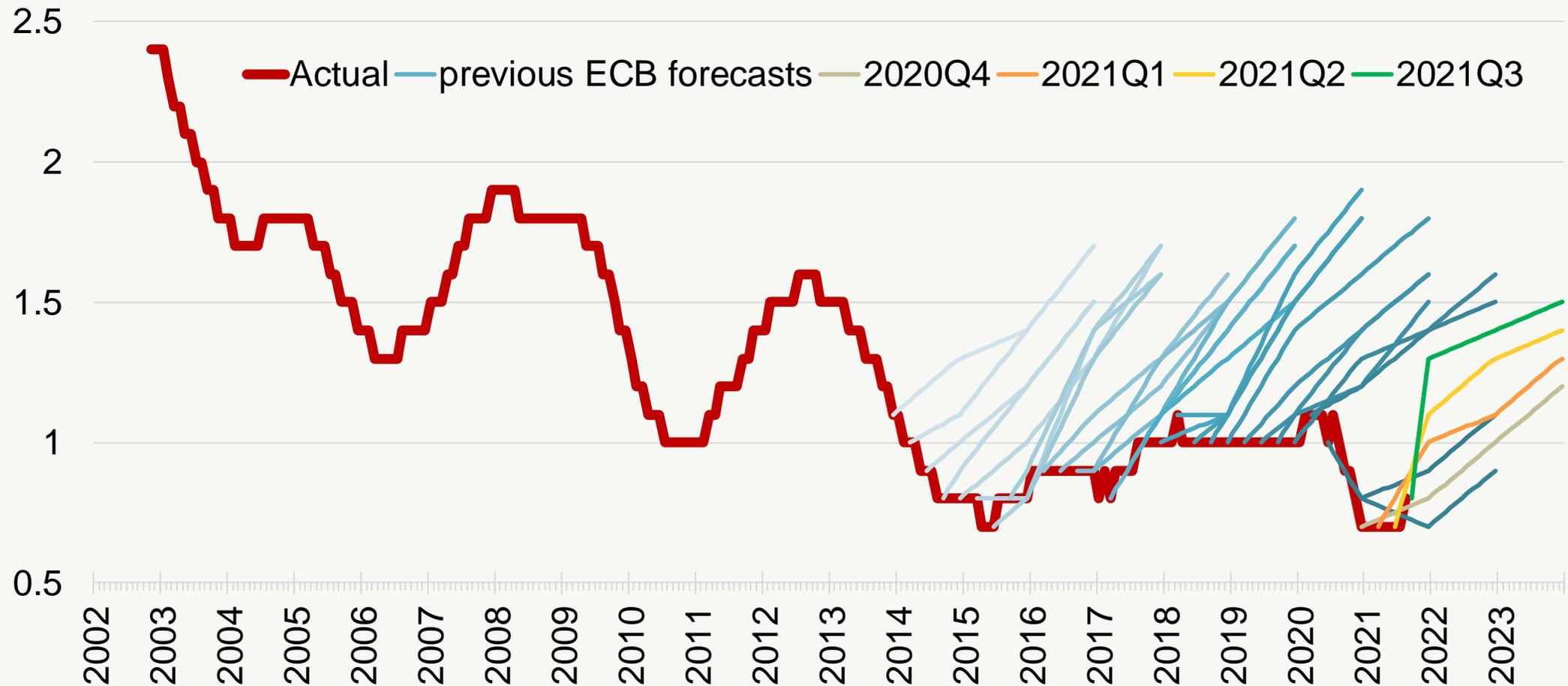
Monetary Dialogue Preparatory Meeting
European Parliament's Committee on Economic and Monetary Affairs
(ECON)

9 November 2021

The Right Reset?

- Useful changes to the monetary policy framework, but:
 - The causes of the **miserable forecasting failure** are unknown
 - The ECB adopted the **FED's previous inflation target** (flexible inflation targeting) and the reason for not adopting the FED's new target (average inflation targeting) is unclear
- The intention to include the costs of owner-occupied housing in the inflation indicator is welcome, but in contrast to the “rental equivalence” method used in the US, ECB and Eurostat seem to favour the “net acquisition” approach, which brings an **asset price component in the inflation indicator**
 - Mixing price stability and financial stability (big issue)
 - The new 2% will be different from the previous 2% (has to happen)

ECB staff macroeconomic projections for euro-area core inflation (moving 12-month average rate of change)



Source: updated from Darvas (2018) using ECB forecasts.

The previous inflation objective of the ECB

- 1998: *"Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%."*
- *"The Governing Council clarified in 2003 that in the pursuit of price stability it aims to maintain inflation rates below, but close to, 2% over the medium term."*
- This dual determination of the objective was unique
- This objective might have been perceived as asymmetric, resulting in more forceful monetary actions in case inflation overshoot 2% than when inflation fell short of 2%. But: see next slide

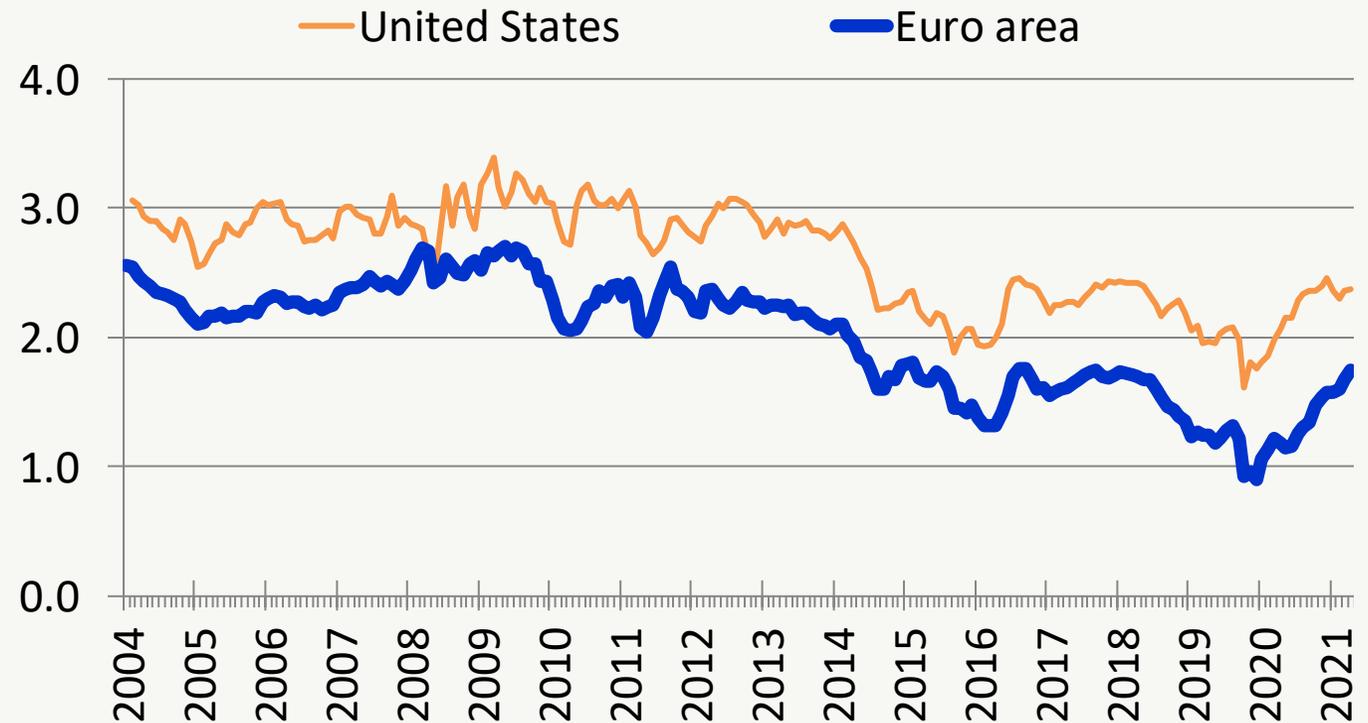
Both actual inflation and expected long-term inflation were close to 2% in 2003-2014 ...

... suggesting that the 2014-2019 inferior inflation outcome cannot be attributed to perceived asymmetry alone.

Maybe asymmetry is more relevant when the interest rate is negative?

Or just bad luck?

Five-year ahead five-year inflation expectations



Source: Bloomberg

July 2021: The new ECB inflation target and indicator

- **Target:** “The Governing Council considers that price stability is best maintained by aiming for *two per cent inflation over the medium term*. The Governing Council’s commitment to *this target is symmetric*. Symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable.”
- **Indicator:** “The Governing Council confirms that the Harmonised Index of Consumer Prices (*HICP*) *remains* the *appropriate* price measure for assessing the achievement of the price stability objective. However, the Governing Council recognises that the *inclusion of the costs related to owner-occupied housing* in the HICP would better represent the inflation rate that is relevant for households.”

Comparison of inflation targets and indicators of four central banks

	<u>ECB (2021)</u>	<u>FED (2020)</u>	<u>BOE</u>	<u>BOJ (2013)</u>
NUMERICAL TARGET	2%	2%	2% (set by the government)	2%
TYPE OF TARGETING	Symmetry	Average over time	Symmetry with bands (+/- 1%)	No explicit reference to symmetry
TIME HORIZON	Medium term	Longer term	Earliest possible time	Earliest possible time
MAIN MEASURE	Harmonised Index of Consumer Prices (HICP)	Personal Consumption Expenditures (PCE)	Consumer Price Index (CPI)	Consumer Price Index (CPI)
INFLATION MEASURE INCLUDES OWNER OCCUPIED HOUSING	In the future	Yes	No	Yes

The inflation target adopted by the Federal Reserve in 2020

- *“In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve **inflation that averages 2 percent over time**, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.”*
- Justification:
 - *“Inflation averaging less than 2 percent over time can lead to an unwelcome fall in longer-term inflation expectations, which in turn can pull actual inflation lower, resulting in an adverse cycle of lower inflation and inflation expectations.”*
 - *“With lower expected inflation, the nominal level of interest rates will be lower too, leaving less room for the FOMC to cut interest rates when needed to support the economy in a downturn.”*
 - *“By seeking inflation that averages 2 percent over time this will help ensure longer-run inflation expectations do not drift down and remain well anchored at 2 percent.”*

The ECB Governing Council did not justify reasons for not opting for average inflation targeting (AIT)

- ECB staff research: Credible AIT lessen negative biases in inflation and economic activity, and also reduce macro volatility. However, “*The effectiveness ... hinges on the degree*
 - *to which they are **credible and well understood** by the private sector,*
 - *the extent to which private sector **expectations are forward-looking** and stable, and*
 - *the consistency of **private sector economic behaviour**”*
- When these conditions are not met, AIT brings less benefits and not superior to simple IT
- Yet some findings can be sensitive to the modelling framework
- ECB modellers persistently failed to forecast inflation in the past decade, undermining the trust in those models

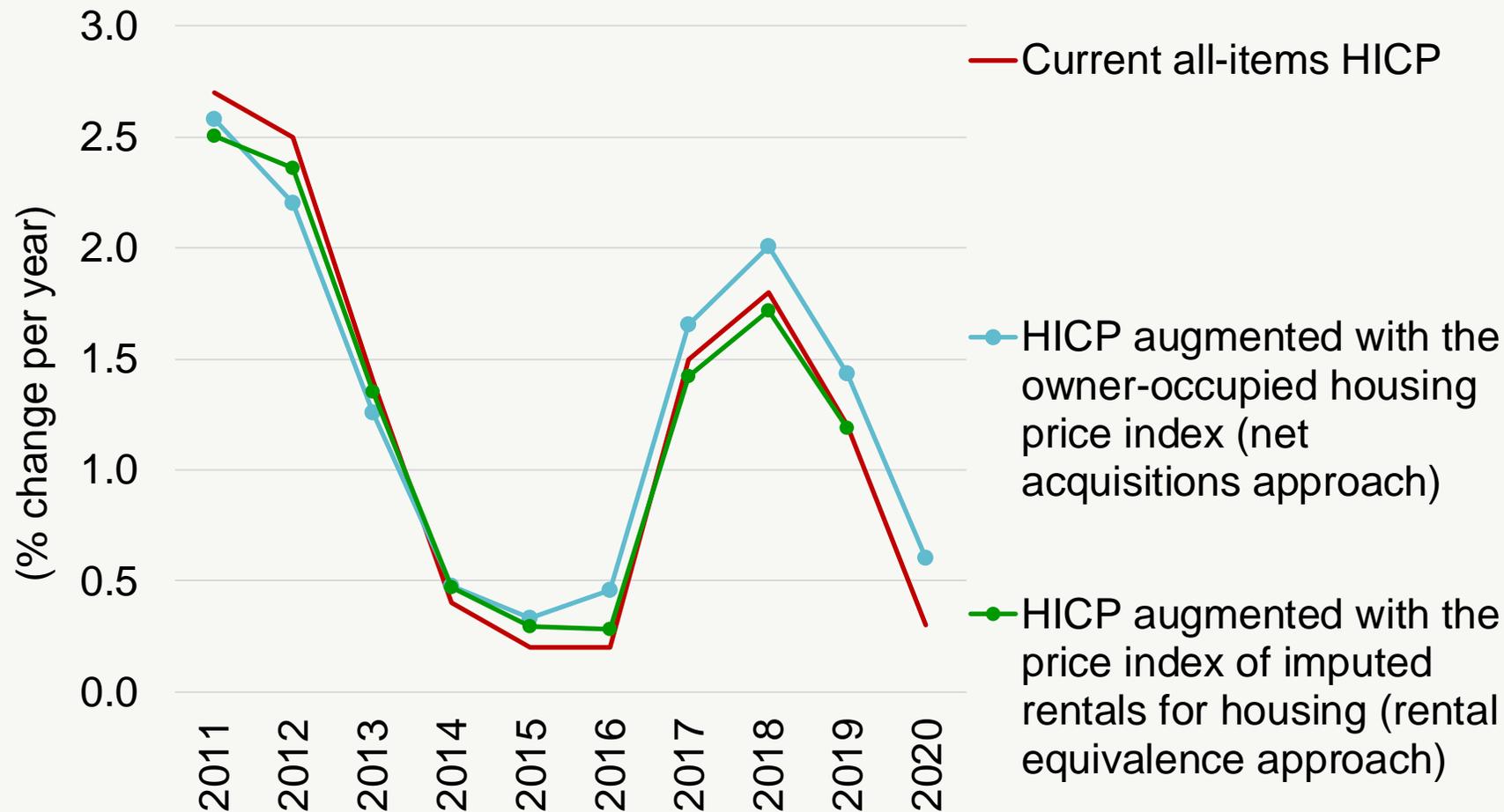
Medium-term remains unclear, as well as its interaction with financial stability concerns

- 2003 Strategy Review: the medium-term horizon was justified to allow for monetary transmission and the ECB to adapt its reactions to different types of shocks
- 2021 Strategy Review – additional reasoning: “*deviation of inflation from the target is context-specific*” and “*to cater for other considerations relevant to the pursuit of price stability*”
- These “*other considerations*” are not specified → discretion & making accountability more difficult
- Financial stability could be one such factor. However, while there are synergies between monetary and financial stability policies, the toolkit should be different

The new inflation indicator: plan to incorporate costs related to home ownership

- 66% of euro-area households are owner-occupiers
- **US** inflation indicators include such costs using the “**rental equivalence method**”: estimating what the market rent would be for an equivalent dwelling in the same area
- The rental equivalence approach is **also used in Europe** in national accounts statistics for the computation of consumption expenditure of households and its price index
- Eurostat and ECB favour the “**net acquisition**” approach for HICP: the purchase of a dwelling is recorded as consumption at the time the transaction takes place
- But a house purchase has **investment and consumption purposes** and no proper method has been developed to separate the two

Exercise deriving an owner-occupied housing costs-augmented HICP using different approaches for the euro area



Source: Bruegel calculations based on Eurostat data.

- Net acquisition approach: the augmented HICP would be on average 0.23 percentage points higher than the actual HICP in 2016-2020
- Rental equivalence approach: hardly any change (0.02%-point difference in 2016-2019)

Main messages

- Changing the previous ambiguous inflation aim to a well-defined target should facilitate a better understanding of ECB intentions
- Yet no clear demonstration of the previous ambiguous aim contributing to the ECB's forecasting failure and the fall in inflationary expectations since 2014
- Structural challenges (reduced real interest rate, demographic changes, uncertain Phillips-curve parameters) remain, as well as dependence on luck
- No clear understanding of the ECB choices different from FED's choices
- The interaction of medium-term orientation for price stability with financial stability concerns remains unclear
- Including the costs of owner-occupied housing in the inflation indicator is a good intention. But the favoured net acquisition approach would involve an asset price in the inflation indicator

Thank you for your attention!