Should the ECB Revise its Inflation Objective?

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SINTRA, NOVEMBER 2020
The Inflation Target in the ECB Strategy

- October 1998: “...year-on-year increase in the HICP for the euro area of below 2%...”
- May 2003: “...below, but close to, 2%...”
- Justification:
  - in line with most NCBs current practice
  - measurement bias
  - safety margin against the risks of deflation...
    - ...in each member country, given likely structural inflation differentials within euro area
    - ...in the euro area, with the consequent risk of hitting the ZLB
The Inflation Target in the ECB Strategy

• “...the available evidence suggests that inflation objectives above 1% provide sufficient safety margins to ensure against [the risk of hitting the ZLB]” (Background Studies 2003)

• Assessment may have been distorted by:
  - “recent experience bias”
  - no evidence of an ongoing decline in r* (e.g. baseline r*=2% used in BS 2003 “...at the lower end of historical estimates”)
The Decline in $r^*$

- Current estimates: $r^* < 1%$
- Driven by structural, long-term factors
- Main implication: given unchanged strategy, higher incidence of ZLB/ELB episodes.
- Needed:
  - Higher inflation target, given an unchanged rule
  - Modified rule, given an unchanged inflation target

Andrade, Galí, Le Bihan and Matheron (2020)
- estimated medium-scale model for the euro area
- welfare-based analysis of the optimal inflation target, given alternative monetary policy rules (with -0.5% ELB constraint)
- main focus: relation between $r^*$ and the optimal inflation target, conditional on alternative policy rules.
The Optimal Inflation Target and $r^*$

Source: Andrade, Galí, Le Bihan, Matheron (2020)
Average Inflation Targeting

Source: Andrade, Galí, Le Bihan, Matheron (2020)
Emergency Fiscal Package [4% if -6%]

Source: Andrade, Galí, Le Bihan, Matheron (2020)
Discussion

- **Countercyclical fiscal policy**
  - Need to relax the SGP
  - Diminished risk of debt crisis with ESM and OMTs.
  - Beyond the ECB’s control

- **Average Inflation Targeting**
  - Easy adoption, can only help in the short run.
  - Formalization of forward guidance
  - Caveat: benefits hinge on anticipation effects + ability to steer inflation with high precision

- **Higher inflation target**
  - Robust to deviations from RE
  - Caveat: transition from current undershooting
  - Transition approach: “gradualism” and “opportunism”

- *The three margins are not mutually exclusive, may want to exploit them simultaneously.*
Final Remarks

- A MP framework is built on some assumptions.
- When the assumptions are revised, the framework must be adjusted accordingly.
- Or else, one must recognize the consequences of not adjusting it.
- Making the current inflation target symmetric is not enough. A change in the target and/or in the rule seems warranted.