

# Should the ECB Revise its Inflation Objective?



**JORDI GALÍ**  
**CREI, UNIVERSITAT POMPEU FABRA AND BARCELONA GSE**

**PANEL ON THE INFLATION OBJECTIVE, STRUCTURAL  
FORCES AND CENTRAL BANK COMMUNICATION**

**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



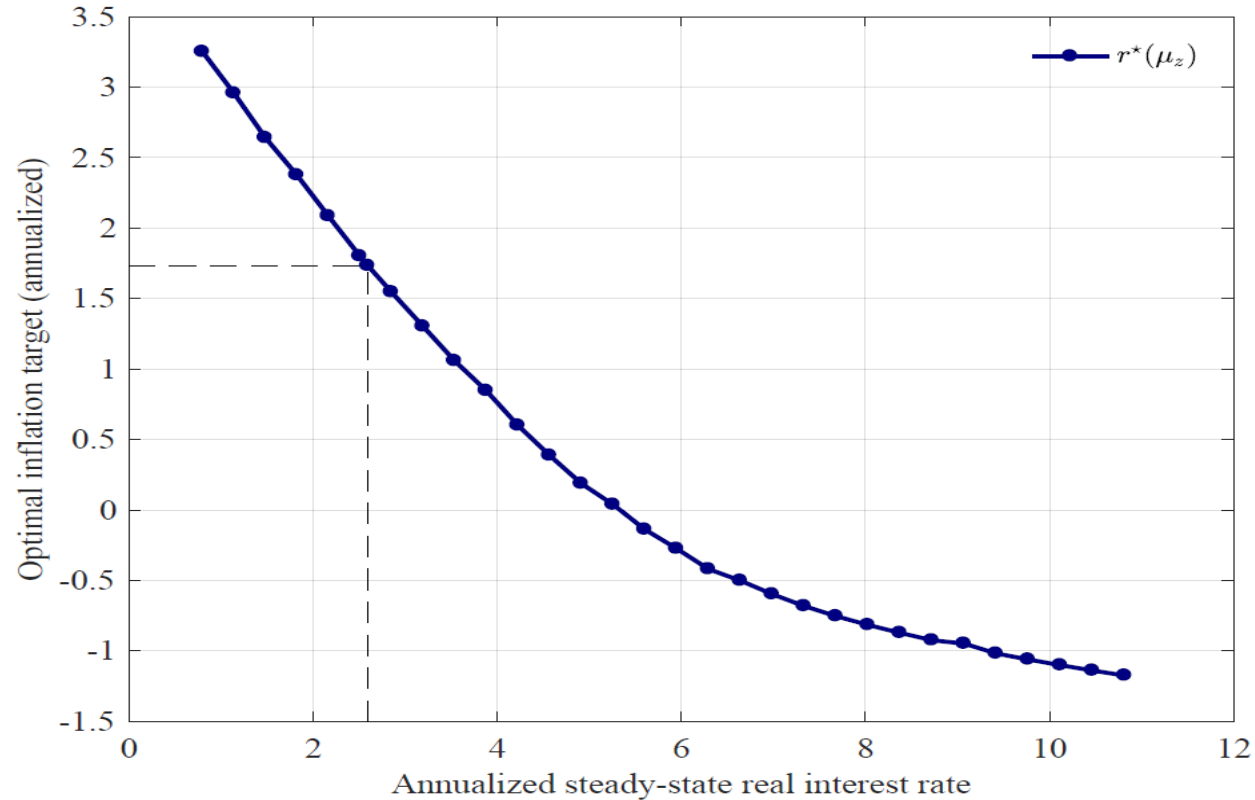
- *“...the available evidence suggests that inflation objectives above 1% provide sufficient safety margins to ensure against [the risk of hitting the ZLB]”  
(Background Studies 2003)*
- Assessment may have been distorted by:
  - “recent experience bias”
  - no evidence of an ongoing decline in  $r^*$  (e.g. baseline  $r^*=2\%$  used in BS 2003 “...at the lower end of historical estimates”)

# The Decline in $r^*$



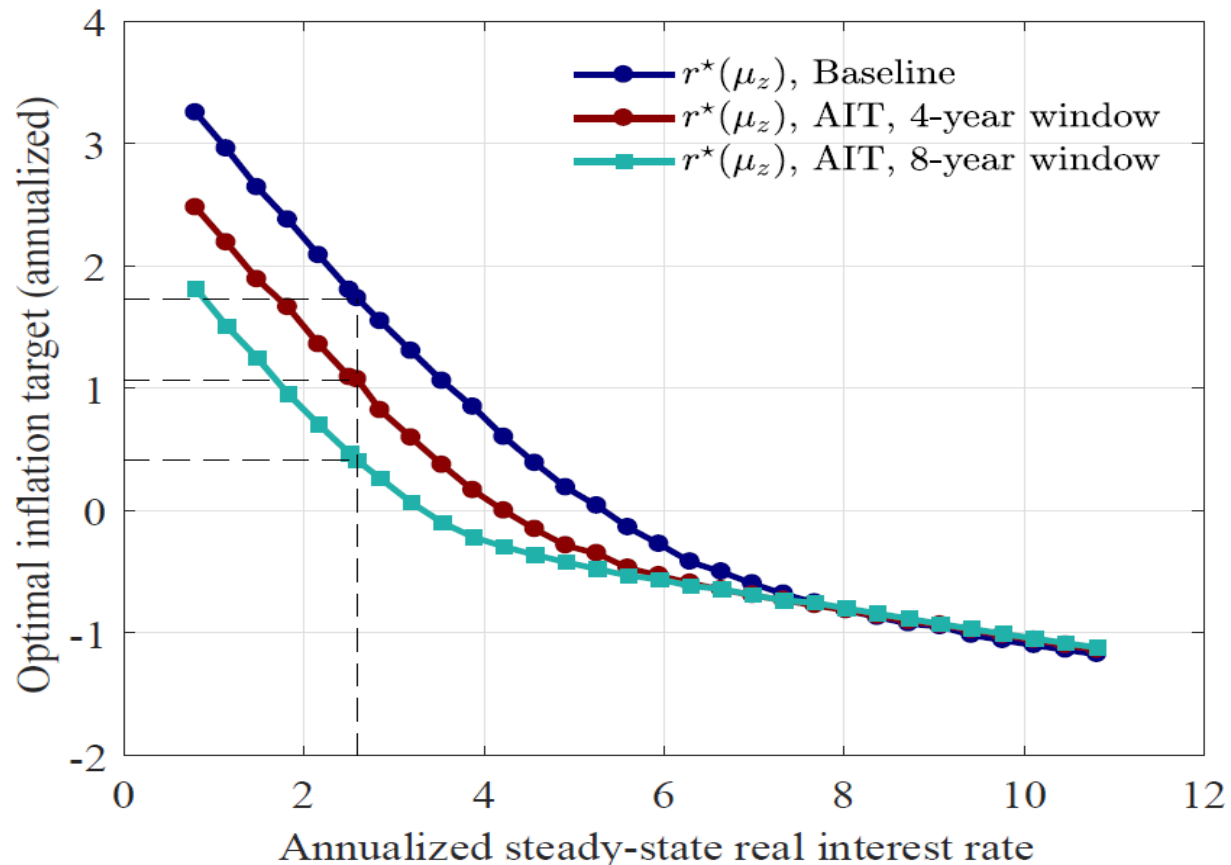
- Current estimates:  $r^* < 1\%$
- Driven by structural, long-term factors
- Main implication: given unchanged strategy, higher incidence of ZLB/ELB episodes.
- Needed:
  - Higher inflation target, given an unchanged rule
  - Modified rule, given an unchanged inflation target
- Andrade, Galí, Le Bihan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

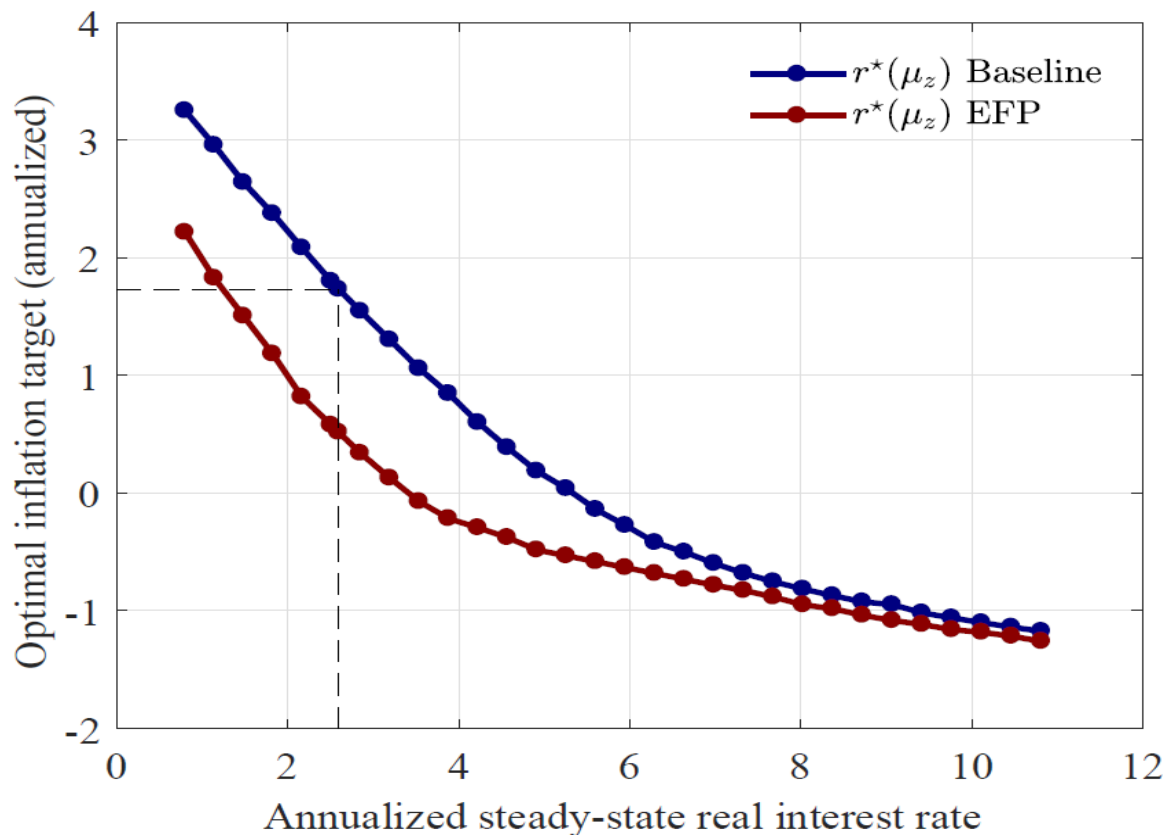


Source: Andrade, Galí, Le Bihan, Matheron (2020)

# Average Inflation Targeting



# 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.