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The ECB's Instruments for Crises and Normal Times: Considerations for the Policy Strategy Review

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Abstract

The ongoing policy strategy review presents a unique opportunity for the ECB to examine how to best employ its immense power to fulfil its mandate. Two challenges require urgent attention. First, the “lowflation” problem – the outcome of overly tight policies that allowed inflation to drift considerably below 2% over the past several years. Second, the impairment of the monetary policy transmission mechanism in the euro area – a key factor behind the divergence of economic performance of different Member States that threatens the viability of the EMU. The ECB has the authority and tools to address these challenges, within its mandate, with suitable corrections in its monetary policy strategy.

Keywords: ECB, lowflation, quantitative easing, spreads, collateral framework.

JEL Classification: E52, E58, E61, H63.

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I. Introduction: The ECB's multiple challenges

The ongoing policy strategy review presents a unique opportunity for the ECB to examine how to best employ its immense power to serve the people of Europe. Much has changed since the ECB last reviewed its policy strategy in 2003. Adaptation is urgently required to address a number of challenges that have become apparent since the Global Financial Crisis (GFC) and pressing problems that have arisen as a result of the ongoing pandemic.

My focus will be on two challenges faced by the ECB: The first relates to monetary policy in a low interest rate environment, when the space for monetary policy accommodation through adjustment of the short-term interest rate is constrained. This challenge is common with other central banks in advanced economies. The second challenge is unique to the ECB and reflects the incomplete nature of the Economic and Monetary Union (EMU). For the ECB, two key problems associated with these challenges have remained unresolved for many years and have complicated the policy response to the pandemic. The first is lowflation: the systematic pursuit of overly tight policies that allowed inflation to drift considerably below 2% over the past several years. The second is the impairment of the monetary policy transmission mechanism in the euro area – a key factor behind the divergence of economic performance of different Member States that threatens the viability of the EMU. These problems suggest inadequacies in the calibration and implementation of monetary policy in the euro area. They also raise questions about the ECB's policy strategy and about possible constraints faced by the ECB. Does the ECB lack the authority or instruments to fulfil its mandate? Or could the ECB better fulfil its mandate simply by adjusting its policy strategy and making better use of its existing authority?

In this paper, I address these questions and offer suggestions on what could be done to address the ECB's multiple challenges. As I explain, the ECB does have the authority and tools to address its multiple challenges, but doing so successfully requires corrections to its policy strategy. The analysis draws heavily on earlier work, in particular, work about monetary policy design in a low interest rate environment from two decades ago (Orphanides and Wieland, 2000) and recent work on the ECB's strategy review (Lengwiler and Orphanides, 2020).

II. The low-interest rate environment and the ZLB challenge

Let me start with a brief review of the Zero Lower Bound (ZLB) challenge. Low interest rates have become a challenge for many advanced economy central banks since the GFC, but this was already a challenge for Japan in the late 1990s. Faced with low inflation and a weak economy, the Bank of Japan became the first central bank to encounter zero interest rates in the post-World War II era. The Japanese experience in the late 1990s prompted research at the Federal Reserve and other central banks, to examine how they should think about monetary policy if they were to encounter a similar challenge. The joint work with Volker Wieland, from which I draw here, was part of the Fed's research program at the turn of the century.

At the time, macroeconomic models used for monetary policy analysis focused on the short-term interest rate as an instrument, and many did not even include any other instruments. But what is the proper response of the central bank in the face of a recessionary shock, if it cannot reduce the short-term interest rate below zero? To address this, we introduced balance-sheet policies in the analysis, which could be activated as needed to preserve price stability.

The ZLB constrains interest rate policy in an asymmetric manner. Policy can be tightened by raising rates in the face of inflationary threats, but not eased sufficiently in the face of disinflationary threats. Monetary policy remains effective, but policy accommodation must be provided by other means such as quantitative easing. When the short rate is constrained, the central bank must shift its attention to balance sheet policies: To provide additional policy accommodation the central bank must expand its balance sheet through purchases of long-term bonds, depressing term premia and longer-term interest rates. Yet, the multipliers and potential side effects associated with quantitative easing are uncertain, which can make policymakers uncomfortable. This may lead to inaction or hesitation to adopt quantitative easing.

The efficient response to the challenge, when examined as a dynamic optimal control problem under uncertainty, is exactly the opposite of hesitation and inaction. Addressing the constraint requires prompt and decisive balance sheet expansion, substituting interest rate cuts for bond purchases. And because the risks are asymmetric and the policy multiplier associated with quantitative easing uncertain, policy must be more aggressive than normal when inflation is below the central bank's goal, even before the constraint is reached. By easing aggressively when short-term rates are near the constraint but not yet constrained, the central bank can be more effective in dealing with the disinflationary shock, and limit the balance sheet expansion that will be required to restore stability later on. By acting preemptively, with aggressive interest rate cuts, the central bank can avert the need for much larger balance-sheet expansions and thus defend against the associated multiplier uncertainty and potential side effects of a bloated balance sheet.

Hesitation to adopt decisive quantitative easing policies when the short-term interest rate is constrained is a costly policy mistake. Unfortunately, it is a mistake we have observed twice during the past two decades. First, in the early 2000s, we saw the Bank of Japan hesitate to adopt forceful QE and systematically undershoot its price stability objective. And then, over the past decade, we saw the ECB fall into the same trap, failing to embrace QE promptly and decisively, which resulted in lowflation.

To understand the ECB's policy error, a comparison with the Fed is informative (Figure 1). Before and during the GFC, inflation developments in the U.S. and the euro area were similar. The economic shock associated with the GFC prompted a massive easing in both economies. Interest rates were cut to zero (and, later on, somewhat below zero by the ECB). With interest rate policy constrained, both the Fed and the ECB had to rely on QE for additional accommodation. A glance at the Fed and ECB balance sheets since the GFC

suggests that while the Fed substituted rate cuts for QE systematically, the ECB has been erratic and relatively timid.

Compare the balance sheet policies of the two central banks since the GFC. While the ECB initially expanded its balance sheet, similarly to the Fed, in mid-2012 the ECB inexplicably started reversing this expansion. The ECB reversed its policy easing even though the euro area economy had not yet recovered from the recession and inflation remained low. From mid-2012 to end-2014, the ECB reduced its balance sheet by one third, a significant quantitative tightening. In 2015, the ECB started to partially correct this mistake, but subsequently continued to keep policy tighter than was required to raise inflation towards 2%.

III. The ECB's lowflation problem

The ECB's pursuit of overly tight policy since mid-2012 guided inflation lower – what the IMF subsequently described as lowflation. Comparing inflation outcomes before and after 2012 illustrates the problem. From 1999 to 2011, the average annual rate of inflation in the euro area was 2 percent (Figure 2). Since 2012, the average has only been 1.1 percent. Is this consistent with the ECB's price stability goal?

The question reflects a basic flaw in the ECB's policy strategy: The ambiguity of its inflation goal. This flaw makes the institution vulnerable to political pressure, especially when the policies needed to deliver on the goal are controversial. The result is suboptimal outcomes for the euro area economy, as observed over the past decade.

To understand the ECB's current predicament, we need to go back to 1998, when the ECB first communicated its definition of price stability. One option was to adopt a clear 2 percent inflation goal. This would have been consistent with the implicit or explicit inflation goal guiding monetary policy in most of the Member States that comprised the euro area. But at the time, recent inflation outcomes in the euro area were somewhat lower, reflecting the temporary drag of the Asian and Russian financial crises. This influenced the discussion and led the ECB to decide in favor of an ambiguous definition of price stability: HICP inflation "below 2 percent." At the time, such ambiguity was not uncommon. Other central banks, including the Fed and the Bank of Japan, also operated with similarly ambiguous definitions of price stability. Of course, such ambiguity imposes an unnecessary cost to the economy. Monetary policy is more effective when inflation expectations are well-anchored, in accordance with the central bank's inflation objective, and inflation expectations can only be well-anchored when the goal is clearly communicated. During the 2000s, and especially after the GFC, attitudes changed and other central banks moved away from the inefficiency of ambiguous definitions of price stability. By 2013, the Fed and BOJ had both adopted a 2 percent symmetric goal as their definitions of price stability, and the ECB was left as the only central bank of an advanced economy with an ambiguous price stability target.

In the meantime, the ECB had partly addressed this flaw by revising its communication following the policy strategy it completed in 2003. The revised communication stated that the

goal was to maintain inflation “close to 2 percent.” Accordingly, under former president Jean-Claude Trichet, the ECB effectively operated with an implicit symmetric inflation target of 1.9 to 2.0 percent. Before the end of his term in 2011, President Trichet repeatedly described the success of the ECB in maintaining an average inflation rate equal to 1.96 percent, stressing the second decimal which reinforced the ECB’s commitment to maintain inflation very close to 2 percent. During the GFC and early in the euro crisis, the ECB benefited tremendously from this communication and clarity of its commitment.

However, this subsequently changed. The ambiguity in the definition of price stability that was communicated in the formal ECB decision in 2003 implied that the risk of political pressure influencing inflation outcomes remained. By 2012, it had become apparent that QE in the form of purchases of government debt would be needed to maintain inflation close to 2 percent. But QE was controversial in some Member States, and the ECB was subjected to unusual legal challenges and political pressure against it. The discomfort associated with the adoption of the QE policies necessary to guide inflation close to 2 percent made it more appealing to just let inflation drift lower. Since the definition of price stability that had been adopted in 2003 remained ambiguous, the meaning of “close to 2 percent” could be interpreted more flexibly, so that it could include much lower inflation outcomes and allow inflation to drift lower. Ambiguity promotes unaccountability and invites political pressure and policy mistakes.

It is important to understand that the lowflation policy pursued by the ECB, starting with the quantitative tightening in 2012, was not an accident. It was the result of deliberate choices driven by the ECB’s hesitation to adopt the QE policies that were necessary to avert it. The ECB’s policy error was evident to observers outside Frankfurt. Characteristic is the following advice given to the ECB in April 2014 by then IMF Managing Director Christine Lagarde:

“There is the emerging risk of what I call ‘lowflation,’ particularly in the Euro Area. A potentially prolonged period of low inflation can suppress demand and output – and suppress growth and jobs. More monetary easing, including through unconventional measures, is needed in the Euro Area to raise the prospects of achieving the ECB’s price stability objective.” (Lagarde, 2014.)

Unfortunately for the euro area, the ECB did not heed Lagarde’s advice and instead continued its quantitative tightening policy. The ECB waited until outright deflation threats appeared in the horizon before embarking on purchases of government debt to expand its balance sheet. And even when it did start these purchases in 2015, the ECB opted for a rather timid expansion that was insufficient to raise inflation consistently towards 2 percent and discontinued the program prematurely.

The lack of clarity about the inflation goal allowed the ECB to deflect criticism that its lowflation policies were inconsistent with its primary objective. Nonetheless, the damage to the euro area economy was done. Demand and output was suppressed, as Lagarde had warned. Restricting nominal GDP growth also worsened debt and deficit ratios, limiting

fiscal space in the euro area (Orphanides, 2020). And inflation expectations were disanchored. As can be seen in Figure 3, both survey expectations as well as market-based measures drifted lower in the period coinciding with the quantitative tightening and then moved sideways when the ECB embarked on its timid QE program in 2015. With the premature discontinuation of QE in 2018, inflation expectations started drifting lower again.

IV. The importance of a clear symmetric 2 percent inflation goal

The disanchoring of inflation expectations and the costs of lowflation in the euro area could have been avoided had the ECB adopted a clear symmetric 2 percent inflation goal and pursued policies guided by such a clear goal. Returning to our earlier comparison of the Fed and the ECB is useful for illustrating the associated benefits of adopting such a strategy even today.

By adopting a clear symmetric 2 percent goal as its definition of price stability, and calibrating QE so as to consistently aim for 2 percent inflation in the medium run, the Fed managed to promote higher growth and maintain inflation expectations in line with 2 percent consistently over the past several years. By embracing QE promptly, the Fed restored normal growth in the U.S. economy and could start normalizing monetary policy – raising rates and reducing its balance sheet somewhat. Actual inflation in the U.S. averaged somewhat below 2 percent over this period, reflecting the presence of global disinflationary forces that similarly affected the euro area and the U.S. economies. But with monetary policy in the U.S. calibrated consistently with a clear 2 percent objective, inflation outcomes have been closer to 2 percent in the U.S. than in the euro area.

The clarity of the inflation goal and consistent calibration of monetary policy in line with the goal also put the Fed in a better position to respond to the ongoing pandemic. Figure 4 compares recent inflation outcomes in the two economies as well as two sets of inflation projections published by the Fed and the ECB, respectively. The projections shown are from December 2019 and September 2020. To facilitate comparisons, the chart shows Q4/Q4 inflation outcomes and projections for the two economies in each year. For the Fed, the projections correspond to median FOMC projections published in the Summary of Economic Projections. For the ECB, the projections correspond to the ECB/eurosystem staff projections.

Three points are pertinent: First, a comparison of actual inflation outcomes from 2010 to 2019 confirms that similar disinflationary forces have affected both economies over the past decade but that the Fed managed to keep inflation closer to 2 percent. Second, the December 2019 projections confirm the differences in policy driven by the ECB's ambiguous definition of price stability. Fed policy was calibrated consistent with maintaining inflation close to 2 percent in the forecast horizon and achieving exactly 2 percent by 2021 and staying there in 2022. By contrast, ECB policy suggested no urgency in correcting the lowflation policy error of the previous years. The ECB's policy calibration was consistent with inflation rising slowly but remaining quite a bit below 2 percent even at the end of the projection horizon.

The third point highlights the usefulness of a clear inflation goal for reinforcing policy and its communication in addressing the ongoing pandemic. Compare the policy communication of the ECB and the Fed embedded in the September 2020 inflation projections. The partial shutdown of the economy due to the pandemic induced a sharp economic downturn in both economies in the first half of this year. The shock has been similar in the two economies and prompted a forceful policy response to support the economy and counter disinflationary dynamics. But are the two central banks equally committed to providing monetary policy accommodation? Comparing the September projections suggests an important difference. In the case of the Fed, the September projections forcefully communicate the Fed's commitment to provide as much monetary accommodation as will be necessary to support the U.S. economy and counteract the disinflationary forces of the pandemic. Despite the severe shock, the Fed is communicating that it will act appropriately, aiming to guide inflation close to 2 percent in 2021 and 2022 and exactly in line with 2 percent by 2023. By contrast, in the case of the ECB, and in light of the vague definition of price stability, no similar commitment for policy action is communicated in the ECB's projections. To be sure, policy was eased in response to the pandemic but the projections suggest lower inflation will be tolerated, and they show no urgency to support the economy as needed to raise inflation anywhere close to 2 percent in the projection horizon.

The contrast is striking: Without a clear inflation goal, the ECB once again appears to shy away from the forceful monetary policy response that could better support the euro area economy, without compromising price stability.

V. Does the ECB lack the authority to do its job?

Let us return to one of the original questions. Does the ECB lack the authority or the tools to fulfil its mandate? Could this explain the ECB's reluctance to ease policy through quantitative easing and to support the euro area economy better by maintaining inflation closer to 2 percent? Does the Fed have greater authority and more tools than the ECB? Is this the reason why the Fed has been able to implement more supportive policies over the past decade than the ECB?

In fact, the opposite is true. Compared to the Fed, the ECB enjoys greater independence and greater discretionary authority to implement the monetary policy best suited to fulfil its mandate. The ECB's authority is clearly described in the Statute (European Central Bank, 2004). To highlight the ECB's vast discretionary authority regarding potential monetary policy tools, consider the following four clauses:

1. The ECB may: "operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement ..." (Art. 18.1.)
2. The ECB may: "conduct credit operations with credit institutions and other market participants, with lending being based on adequate collateral." (Art. 18.1.)

3. “The ECB shall establish general principles for open market and credit operations ...” (Art. 18.2.)
4. “The Governing Council may, by a majority of two thirds of the votes cast, decide upon the use of such other operational methods of monetary control as it sees fit, respecting Article 2.” (Art. 20.)

Article 18 of the Statute, gives more than enough authority to the ECB to do its job. It gives the authority to the ECB to purchase assets and implement quantitative easing as needed to raise inflation close to 2 percent, in line with its price stability objective. In addition, it gives the ECB vast authority to engage in credit operations, using its discretion to define what is “adequate collateral” for such operations. And it gives the ECB the discretionary authority to establish the “general principles” for these operations. Asset purchases and collateralized lending operations are the two main tools needed for monetary policy. But just in case the tools described in Article 18 ever proved insufficient, examine the additional authority provided by Article 20. The Governing Council has the discretionary authority to adopt other tools, “as it sees fit”!

The ECB has greater discretionary authority and more tools to fulfil its mandate than any other Central Bank I know of. Lack of authority or lack of tools is not the explanation for the inadequacies in the calibration and implementation of monetary policy observed in the euro area.

VI. The impairment of the monetary policy transmission mechanism

The second issue I want to highlight is the impairment of the monetary policy transmission mechanism observed in the euro area over the past decade or so. As already mentioned, this is a key factor behind the divergence of economic performance of different Member States, which has been a threat to the viability of the EMU since the GFC. Figure 5 shows the spreads of two-year sovereign yields from OIS rates in six advanced economies inside and outside the euro area. It includes the United States, Japan, and the four largest Member States of the euro area: Germany, France, Italy, and Spain. The spread between sovereign yields and OIS can serve as a useful indicator of the functioning of the monetary policy transmission mechanism. When the monetary policy transmission works well, spreads are very small, a few basis points, regardless of the currency or the level of policy interest rates. For the United States and Japan, the spreads confirm that the monetary policy transmission has been working fairly smoothly over the past two decades, including in periods of severe financial stress, as experienced during the GFC. Before the GFC, this was also the case in the four Member States shown in the figure. ECB monetary policy, including easing and tightening cycles, was transmitted evenly across the euro area. Unlike in all other advanced economies, this changed after the GFC, with a severe disruption in the transmission mechanism observed during the peaks of the euro crisis. This proved not to be a temporary problem. As is clearly visible from the figure, the ECB has not managed to address the problem satisfactorily since then.

The impairment of the monetary policy transmission mechanism in the euro area reflects flaws in the ECB's monetary policy implementation strategy that require attention in the context of the ongoing review. The problem can be traced to the ECB's excessive reliance on "markets" and private credit rating agencies for policy implementation, reflecting practices unlike those found in the policy implementation strategy of any other peer central bank. This is the result of past discretionary ECB decisions that have proven highly destabilizing for the euro area and demand closer scrutiny. The underlying issue is associated with the well-known existence of multiple self-fulfilling expectational equilibria in sovereign markets that can arise if the central bank adopts a policy implementation strategy that accommodates them. If the central bank appropriately focuses on economic fundamentals, adverse self-fulfilling equilibria cannot be supported. Unfortunately for the euro area, the ECB has been using its discretionary authority in a manner that can inadvertently have the opposite effect, validating adverse expectational equilibria in sovereign debt markets for some Member States. (De Grauwe and Yi (2013) provide empirical evidence of the adverse outcomes.)

In the aftermath of the GFC, the ECB's monetary policy implementation strategy has inadvertently encouraged the appearance of unwarranted debt default scares in several Member States. This has been the main cause of the impairment of the monetary policy transmission mechanism. To improve the functioning of the monetary policy transmission mechanism, it is important to identify and correct ECB discretionary decisions that have contributed to the impairment.

Consider, for example, the framework the ECB has adopted for performing debt sustainability analysis (DSA) for its Member States. Other advanced economy central banks do not typically conduct such analyses. Nonetheless, in the context of the euro area, with the ECB being responsible for the common monetary policy in a monetary union, such analyses can serve a useful role. In principle, it may be sensible to check that the fiscal policy of individual Member States is sustainable over time to avoid concerns of fiscal dominance, and to protect against the deficit bias that might be manifested in monetary unions. However, care is required in such analyses to rely on economic fundamentals so as to avoid encouraging the convergence of beliefs to adverse expectational equilibria. The crucial assumption regards the interest rate adopted for evaluating the cost of refinancing maturing debt. In the presence of multiple equilibria, a Member State's economic fundamentals may support both an equilibrium with negligible credit risk and a low cost of refinancing as well as an adverse self-fulfilling equilibrium with a higher interest rate reflecting significant credit risk that arises because of the higher cost of refinancing maturing debt. To avoid inadvertently validating adverse equilibria, DSA should not rely on market-based interest rate projections. And yet, the ECB has decided to do exactly that. The ECB's DSA methodology relies on market-based interest rate projections, including potentially unwarranted credit spreads, thereby validating adverse expectational equilibria even when economic fundamentals could support equilibria without excessive spreads.

Consider the ECB's decision to delegate the determination of collateral eligibility of government debt of its Member States to private credit rating agencies. This decision introduced a destabilizing cliff effect in the ECB's collateral framework – a unique feature among peer central banks. If a Member State has a rating above some threshold, the ECB considers its government debt eligible collateral. Below the threshold, the debt becomes ineligible, effectively destroying the liquidity value of government debt for that Member State. The destabilizing nature of this decision was not sufficiently appreciated when the decision was made in 2005 but its adverse effects have been repeatedly demonstrated since the GFC. The problem is that the loss of collateral eligibility as a result of a downgrading induces debt roll-over risk. During a panic, fears of downgrades and potential default become self-fulfilling as investors must account for the possibility that the ECB may refuse to accept government debt as collateral, even for sovereigns with sound fiscal fundamentals.

In effect, since the GFC, the ECB's monetary policy implementation strategy has been inadvertently inducing fears of debt roll-over crises that would have been unwarranted had the ECB adopted better practices. As a consequence, monetary policy has been transmitted unevenly across euro area Member States, which in turn has contributed to divergences across the euro area, with some Member States unnecessarily being subjected to severe stress.

Has the ECB made satisfactory use of the authority delegated to it for the implementation of monetary policy in the euro area? Clearly not, judging from the experience of the past decade. However, since the start of the pandemic earlier this year, the ECB has shown a different side, which I examine next.

VII. The response to the pandemic

One way to examine the ECB's response to the pandemic is through the lens of government bond markets. This is informative regarding the ECB's relative success to protect against the impairment of monetary policy, compared to other episodes of severe stress observed since the GFC. Figure 6 shows the 10-year government bond yields for the four largest Member States together with the corresponding OIS rate.

The vertical lines correspond to three dates: The first is 12 March 2020, when ECB President Lagarde stated: “we are not here to close spreads.” This communication mishap initially roiled markets, as reflected in the figure. However, the ECB Governing Council and President Lagarde deserve credit for recognizing the vulnerability and taking steps towards restoring stability and improving the transmission of monetary policy.

In subsequent days, conditions in government bond markets deteriorated with the recognition that the pandemic was spreading and was likely to result in a severe contraction in economic activity. The adverse market reaction also suggested concerns among market participants for whether the ECB would take forceful measure to support the economy and government bond markets. The introduction of the pandemic emergency purchasing program (PEPP) on 18

March was a significant step towards alleviating these concerns. As can be seen, bond markets rallied in response to the PEPP, as reflected in notable declines in yields.

However, the PEPP-induced rally was short-lived. As can be seen in the figure, within a few days yields on the government bonds of France, Spain, and Italy started rising again. One important source of instability remained unresolved. Bond purchases did not address the cliff effects in the ECB's collateral framework and the potential debt roll-over crises that could follow decisions by private credit rating agencies to downgrades Member States with ratings close to the cliff. Fortunately, the ECB preempted the downgrades with a critical decision taken on 22 April: Using its discretionary authority, under Article 18 of the Statute, the ECB Governing Council decided to temporarily suspend the role it had delegated to private credit rating agencies to determine collateral eligibility, until September 2021. In this manner, the ECB provided collateral certainty and finally succeeded in diffusing the tensions that had dominated markets since early March.

VIII. Two urgent matters for the monetary policy strategy review

Before the pandemic, the ECB embarked on a welcome strategy review. On 23 January, it announced the review as follows:

“As our economies are undergoing profound changes, it is the time for a strategy review to ensure we deliver on our mandate in the best interest of Europeans.”
(European Central Bank, 2020.)

The pandemic delayed some of the work on the review and the ECB postponed its completion to mid-2021. But the pandemic also made improvements to the pre-pandemic monetary policy strategy more urgent. It also forced the ECB to embrace temporary deviations from its existing policy strategy to partially address known flaws.

Should corrections to known flaws in the ECB's monetary policy strategy wait another year? To limit the lasting damage from pandemic, improvement of the ECB's policy strategy is a matter of urgency.

Two issues stand out and must be addressed to make policy more effective: First, the ECB should adopt a clear, symmetric 2 percent inflation goal and calibrate QE in a systematic matter to achieve this goal. Providing ECB Governing Council inflation projections similar to other central banks, would buttress the ECB's commitment to implement policies consistent with its 2 percent inflation goal. These steps would help re-anchor inflation expectations and improve economic outcomes. Certainly, it would have been better to adopt the 2 percent goal much earlier. That would have better protected the ECB from the political pressure, legal challenges, and policy mistakes that led to lowflation. Regardless, the sooner the ECB adopts a clear, 2 percent inflation goal, the better.

Second, and even more important, the ECB must correct the fragility-inducing aspects of its policy implementation strategy. The ECB can draw on the success of the temporary measures adopted in response to the pandemic. It should eliminate cliff effects in its collateral framework on a permanent basis. It must end the delegation of the determination of collateral eligibility of government debt to private credit rating agencies. It certainly does not reflect well on the ECB that its monetary policy implementation strategy has been inadvertently inducing instability in government bond markets for so long. The ECB deserves credit for the decision to temporarily suspend the most destabilizing aspect of its collateral framework until September 2021, but must convert the short-term patches to permanent corrections.

The ECB has the authority and the tools to deliver on its mandate better than in the past. In the best interest of Europe, improvement of the ECB's policy strategy is a matter of urgency.

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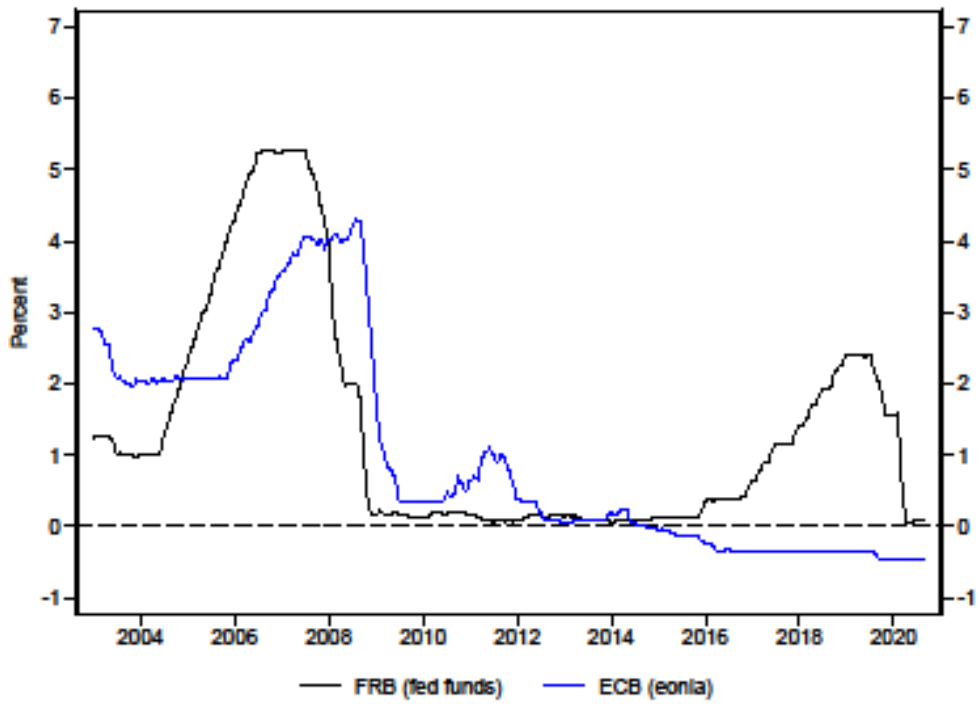
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Figure 1: ECB monetary policy compared to Federal Reserve

Overnight interest rate



Size of balance sheet

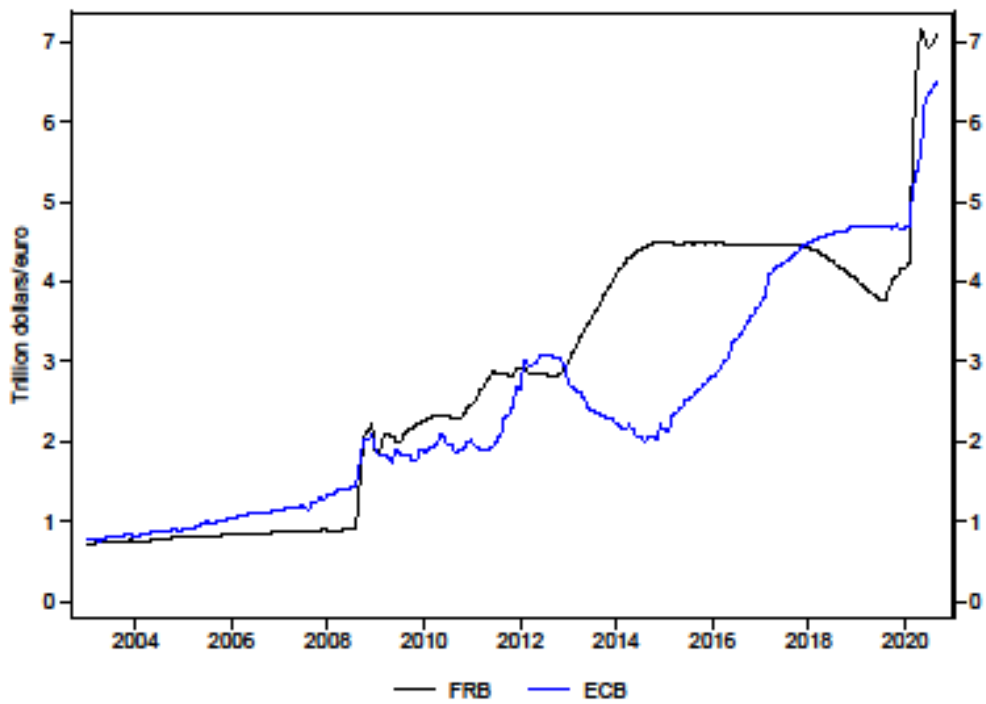
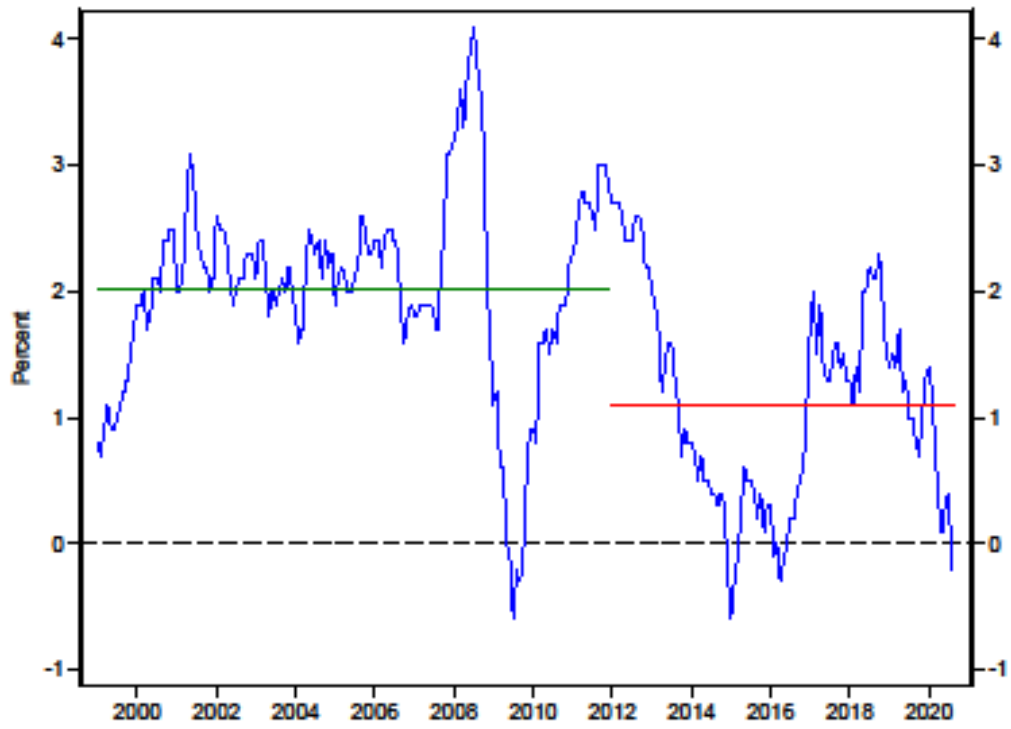


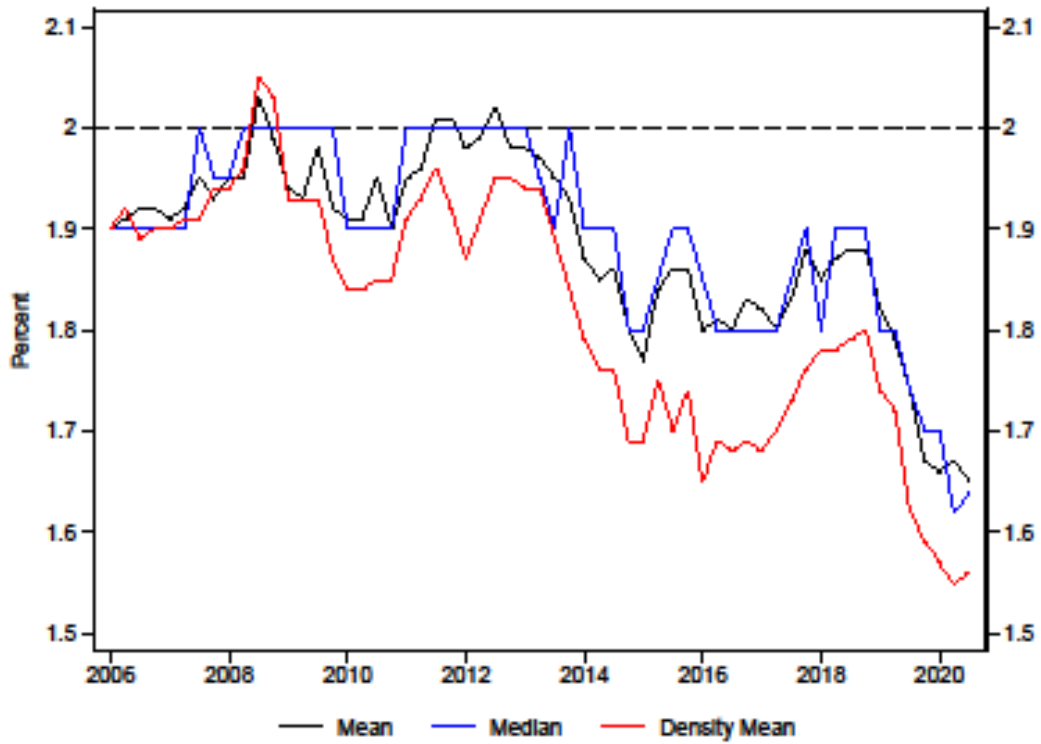
Figure 2: The ECB's lowflation policy: 2012—?



Notes: HICP monthly data.

Figure 3: Disanchoring of inflation expectations

Long-term survey expectations



Inflation swaps

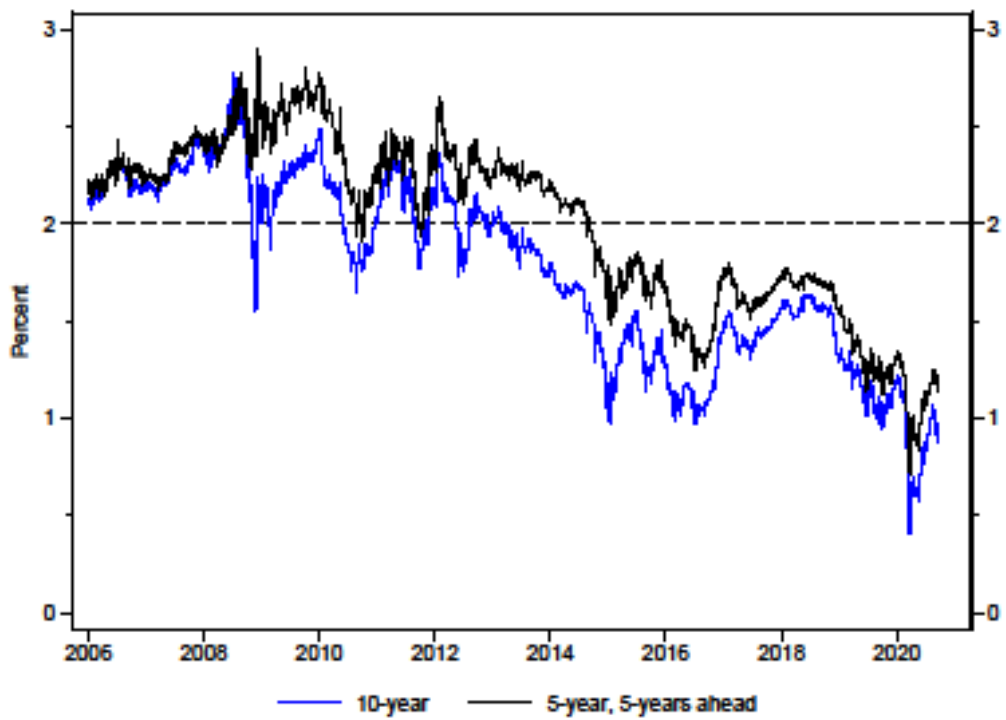
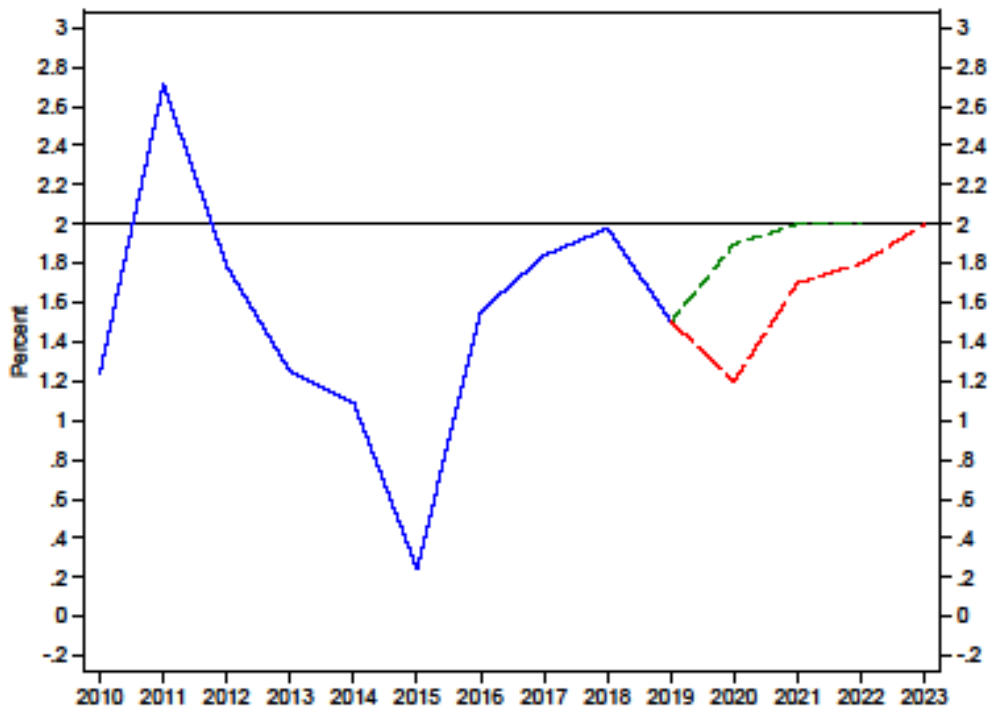
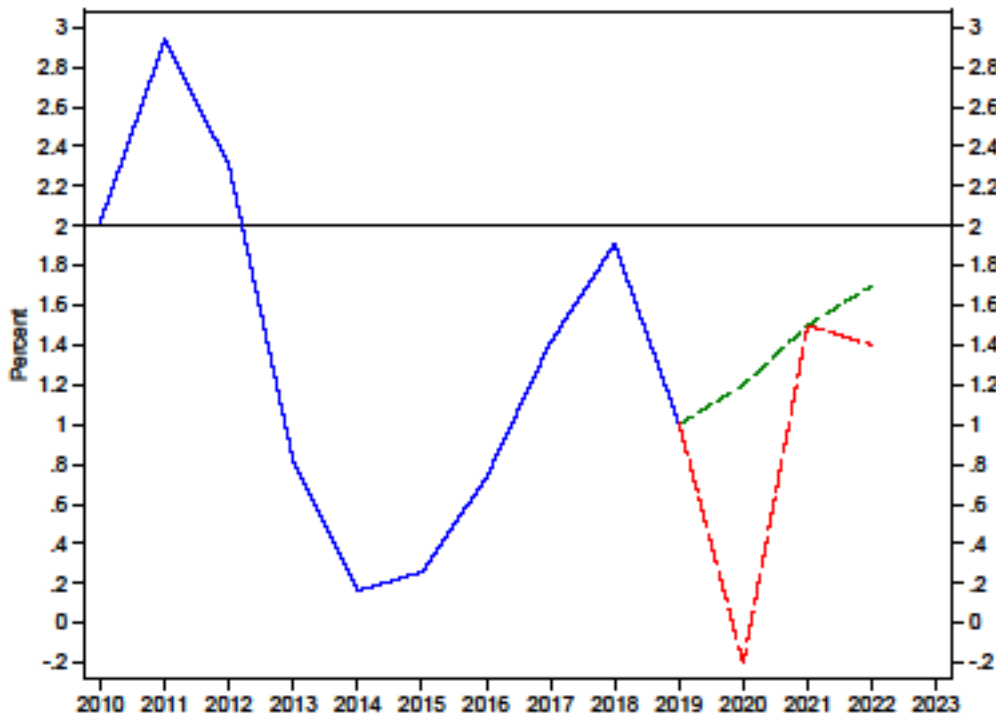


Figure 4: Inflation and recent projections

Fed (PCE)



ECB (HICP)



Notes: Q4/Q4 inflation data in blue. December 2019 projection in green. September 2020 inflation projection in red.

Figure 5: Spreads of two-year sovereign yields from OIS rate

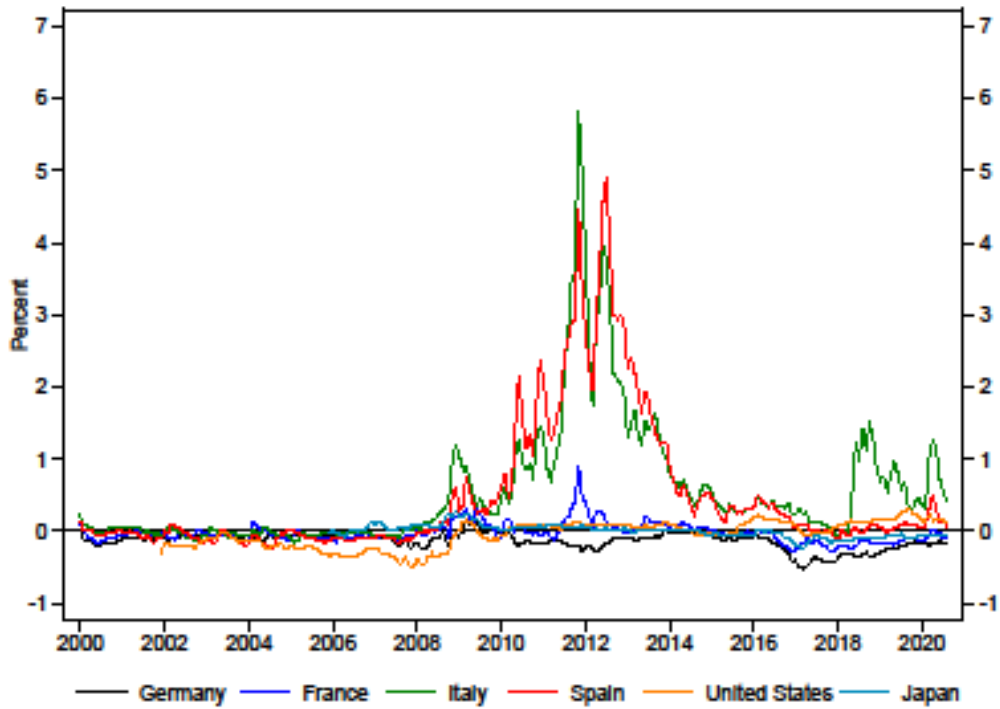


Figure 6: Ten-year yields on sovereign debt and OIS rate

