BLOG

Don’t blame the mirror if your face is faulty – assessing the symmetry of the ECB´s monetary policy responses

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The symmetry of the guideline for the monetary policy stance has recently attracted considerable attention in central banks’ communications. [1] Both the Fed and the ECB have, in their recent strategy reviews, laid out that their preferences are symmetric about the inflation target of 2%. Indeed, the calibration of the inflation target was a key part of the ECB’s strategy review that was published in July.

Previously, price stability was deemed to be achieved when the year-on-year increase in consumer prices (as measured by the HICP) for the euro area was under 2% over the medium term. In addition to this definition, the Governing Council of the ECB had clarified, back in 2004, that it is pursuing a year-on-year increase in prices that is below, but close to 2%. This clarification narrowed down the range of inflation outcomes that could be targeted by the ECB’s Governing Council, yet, close-but-below was still an expression that could hardly be seen as symmetric.

What does a symmetric monetary policy target really mean?

The Governing Council of the ECB started in July 2019 to communicate about its *commitment to symmetry in the inflation aim* in the context of its monetary policy meetings. Nevertheless, for example in the Wikipedia article ‘*Symmetrical inflation target*’ the ECB was referred to an example of a central bank with an asymmetric inflation target. What was the reason behind these different interpretations?

Symmetry of the inflation target can refer to a number of things. The degree of symmetry can be divided into at least three types:

1. Mild: *the central bank not only aims at decelerating inflation that is above the target, but also raises it when it is below target.*

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1. "Don't blame the mirror if your face is faulty" is an old Russian saying, used as the motto in *the Government Inspector* by Nikolai Gogol.

2. Medium: *the calibration of the central bank's measures in response to the deviation of inflation from the target does not depend on whether inflation is above or below target (ex ante symmetry);*
3. Strong: *the central bank calibrates its monetary policy measures so that actual inflation is at target level on average, and long-term inflation expectations are anchored at the target (ex post symmetry).*

Regarding the first criterion, the ECB was undoubtedly symmetric already before the strategy review. It had frequently eased its monetary policy stance to raise inflation when medium-term inflation expectations had been clearly lower than the target level of close to two per cent.

Yet, assessing the calibration of the monetary policy measures is much more difficult. Based on the experience of recent years we know that the key interest rates can be pushed below zero, but on the other hand not too deep into negative territory without severe disruptions in financial intermediation.

Currently, when the natural real rate of interest in the euro area is low, it is easier to slow a rising rate of inflation by large increases in the key interest rates than it is to push up falling inflation by extensive cuts in the key policy rates. *Due to the lower bound of interest rates, the central bank's traditional tool – the steering of interest rates via the key policy rate – functions asymmetrically*.

In response to the asymmetry related to interest rates, the ECB has introduced non-standard monetary policy measures. However, it's more difficult to anticipate the effectiveness of these measures than the effectiveness of conventional measures, such as interest rate adjustments. It is logical to assume that the central bank's normal tools are the most effective for steering inflation, and therefore deviations from the target level of inflation are more persistent when the key interest rate cannot be lowered due to the lower bound of interest rates.

The asymmetry of the toolbox thus leads to a situation in which negative deviations are more persistent than positive deviations. If this is the case, inflation can on average *ex post* be lower than target, even if the *ex ante* target is symmetric.

The symmetry of monetary policy responses can be assessed ex post. In case of the ECB, it seems that, before the strategy review, the central bank had either reacted more strongly to upside pressures on inflation than to downside pressures, or alternatively, it has reacted symmetrically around a target that is clearly below 2%. [2] Empirically, however, it was difficult to establish whether the ECB had reacted asymmetrically or whether the ambiguously defined inflation aim had been lower than assumed by many observers. [3]

Fulfilment of the third criterion of symmetry can be assessed based on market prices. If we examine inflation expectations five years ahead, the expectations reflect mainly the target derived from the central bank's strategy and the credibility of the target. Prior to

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2. https://www.ijcb.org/journal/ijcb21q2a4.htm
3. Reading between the lines - Using text analysis to estimate the loss function of the ECB (helsinki.fi)

the strategy review, these long-term market expectations had in the euro area been below 2 per cent for more than five years (on average even below 1.5%). Thus, based on this measure, euro area inflation expectations had not been anchored at close to 2% in recent years.

The European Central Bank's new strategy and symmetry

The anchoring of inflation at the target level requires the fulfilment of three conditions:

i) the inflation target at which the central bank wants to anchor the expectations must be unambiguous;

ii) the central bank must have the willingness to calibrate its monetary policy in line with the target; and

iii) the central bank must have the ability to calibrate its monetary policy as required by the target.

How does the ECB's renewed strategy meet these three conditions?

First, the previous combination of the definition of price stability and the ambition *'below, but close to 2%'*, which left room for interpretation and was seen asymmetric, is now replaced with an unambiguous and symmetric 2%:

"*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. The* ***two per cent inflation target provides a clear anchor for inflation expectations****, which is essential for maintaining price stability*".

Second, the effect of the asymmetry of the monetary policy toolbox is reduced by a pledge for a stronger reaction in a situation in which there is a risk of the interest rate hitting the effective lower bound:

"*To maintain the symmetry of its inflation target,* ***the Governing Council recognises the importance of taking into account the implications of the effective lower bound****. In particular, when the economy is close to the lower bound, this* ***requires especially forceful*** *or persistent* ***monetary policy measures*** *to avoid negative deviations from the inflation target becoming entrenched*".

Even though the central bank would, as a rule, strive to prevent the interest rate from hitting the lower bound by reacting forcefully (i.e. asymmetrically) to opposite deviations, shocks to the economy can be so severe that the interest rate will hit the lower bound, despite the forceful monetary policy measures taken.

In that case, the economy will experience **an inflationary gap**, caused by the asymmetry of the monetary policy toolkit, and the ultimate reason of which is the central bank's inability to boost economic activity on the lower bound of interest rates.

As long as the natural rate of interest remains low this is not only a theoretical possibility but a state into which the economy can be expected to drift from time to time. The more persistent and frequent these inflationary gaps are, the more likely it is they will start to lower average inflation and hence inflation expectations.

The central bank can compensate the inflationary gap caused by the lower bound of the interest rate by allowing inflation that is temporarily above target. An example of this is the US Federal Reserve that complemented its monetary policy strategy last autumn with this type of compensation element (referred to as a make-up strategy or average inflation targeting).

The ECB's new strategy addresses this issue with a similar approach. The Monetary Policy statement lays out that:

"*In particular, when the economy is close to the lower bound, this requires especially forceful or* ***persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target***".

The new strategy that aims at compensating the inflationary gap would not necessarily lead to more accommodative monetary policy on average. Its mere existence could create certainty on the markets and thus contribute to maintaining inflation expectations anchored, without the need for extreme use of non-standard monetary policy measures.

In addition, when economic agents can rely on the fact that the inflationary gap will be compensated later and that long-term inflation expectations will remain anchored at the level set by the price stability objective, the central bank may seek to raise inflation with more moderate measures when the interest rate has hit the lower bound. Overall, the ECB's new monetary policy strategy, with its unambiguous and truly symmetric inflation target, will facilitate the solid anchoring of inflation expectations and provide a solid basis for effective monetary policy responses in various circumstances and even during economic crises, the latter of which we will hopefully witness less in the coming years.

Tags

ECB, inflation targeting, monetary policy, monetary policy strategy