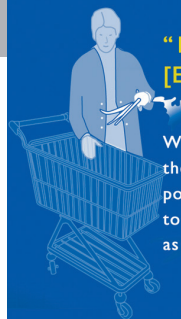


# PRICE STABILITY – OBJECTIVE OF THE EUROSISTEM

## PRICE STABILITY – OBJECTIVE OF THE EUROSISTEM

MONETARY POLICY

Article 105 of the Treaty establishing the European Community:



“1. The primary objective of the ESCB [Eurosystem] shall be to maintain price stability.

Without prejudice to the objective of price stability, the ESCB [Eurosystem] shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2.”



© EUROPEAN CENTRAL BANK MP.001 08/06

The primary objective of the Eurosystem is to maintain price stability. This is the key provision of the monetary policy chapter of the EC Treaty. By focusing the monetary policy of the ECB on this objective, the Treaty incorporates modern economic thinking about the role, scope and limits of monetary policy and underlines the institutional and organisational set-up of central banking in EMU.

The objective of maintaining price stability has been assigned by the EC Treaty for good reasons.

First, decades of practical experience and a large number of economic studies suggest that monetary policy will contribute most to improving economic prospects and raising the living standards of citizens by maintaining price stability in a lasting way.

Second, the theoretical foundations of monetary policy as well as experience drawn from the past demonstrate that monetary policy can ultimately only influence the price level in the economy. Thus, maintaining stable prices is the only feasible objective for the single monetary policy over the medium term. By contrast, apart from the positive impact of price stability, monetary policy has no scope for exerting any lasting influence on real variables.

The Eurosystem is required to act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

## PRICE STABILITY – DEFINITION

Although the EC Treaty clearly establishes maintaining price stability as the primary objective of the ECB, it does not define what “price stability” actually means. With this in mind, in October 1998 the Governing Council of the ECB announced a quantitative definition of price stability.

The Governing Council of the ECB has defined price stability as “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%”. Price stability “is to be maintained over the medium term”.

The Governing Council confirmed this definition in May 2003 following a thorough evaluation of the ECB’s monetary policy strategy. On that occasion, the Governing Council clarified that, within this definition, it aims to maintain inflation rates below but close to 2% over the medium term.

The reference to “the HICP for the euro area” indicates that the goal of the ECB’s monetary policy is price stability in the euro area as a whole, and that it aims to give full and effective protection against losses in the purchasing power of money. The HICP is the index that most closely approximates the

changes over time in the price of a representative basket of consumer goods and services purchased by euro area households.

The phrase “below 2%” sets a clear upper boundary for the rate of measured HICP inflation that is consistent with price stability over the medium term. At the same time, aiming for low positive inflation rates “close to 2%” provides “an adequate margin to avoid the risks of deflation”. Likewise, the ECB’s quantitative definition of price stability takes into account the possible presence of a measurement bias in the HICP and the implications of inflation differentials of a structural nature within the euro area.

The wording “over the medium term” signals that monetary policy cannot fine-tune developments in prices or inflation over short horizons of a few months. Changes in monetary policy always affect prices with a significant time lag, and the magnitude of the eventual impact is uncertain. This implies that monetary policy cannot offset all unanticipated shocks to the price level in a short period of time. Some short-term volatility in inflation is therefore inevitable.

## PRICE STABILITY – DEFINITION

MONETARY POLICY

“Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term.”

The Governing Council aims to maintain inflation rates at levels below, but close to 2% over the medium term.



© EUROPEAN CENTRAL BANK MP.002 08/06

## REASONS FOR THE QUANTITATIVE DEFINITION

There are three main reasons for announcing a quantitative definition of price stability:

1. By clarifying the aims of monetary policy, the definition helps to make monetary policy more transparent.
2. A quantitative definition provides a yardstick against which the public can hold the ECB accountable. As deviations of price developments from price stability can be easily identified by the citizens, the ECB must explain how price stability will be restored within an acceptable period of time.
3. The definition provides guidance to the public for forming expectations of future price developments. Stabilising longer-term inflation expectations in line with price stability facilitates the task of monetary policy and enhances its effectiveness.

# BENEFITS OF PRICE STABILITY

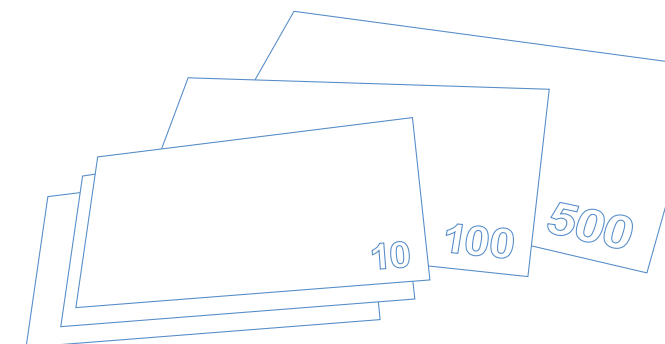
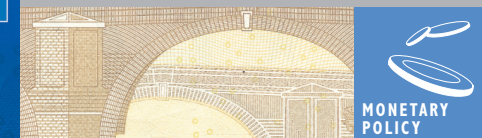
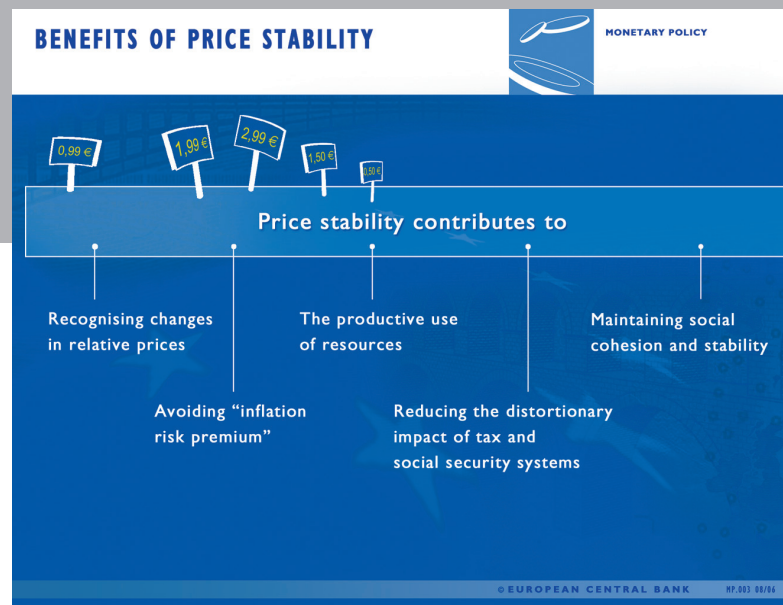


The objective of price stability refers to the general level of prices in the economy and implies avoiding both prolonged inflation and deflation. Price stability contributes in several ways to achieving high levels of economic activity and employment:

1. Price stability makes it easier for people to recognise changes in relative prices since such changes are not obscured by fluctuations in the overall price level. This enables firms and consumers to make better-informed decisions on consumption and investment. This in turn allows the market to allocate resources more efficiently. By helping the market to guide resources to where they can be used most productively, price stability raises the productive potential of the economy.
2. If investors can be sure that prices will remain stable in the future, they will not demand an “inflation risk premium” to compensate them for the risks associated with holding nominal assets over the longer term. By reducing such risk premia in the real interest rate, monetary policy can contribute to the allocative efficiency of the capital market and thus increase the incentives to invest. This in turn fosters economic welfare.

3. The credible maintenance of price stability also makes it less likely that individuals and firms will divert resources from productive uses to hedge against inflation. For example, in a high inflation environment there is an incentive to stockpile real goods since they retain their value better than money or some financial assets in such circumstances. However, stockpiling goods is not an efficient investment decision, and therefore hinders economic growth.
4. Tax and welfare systems can create perverse incentives that distort economic behaviour. In most cases, these distortions are exacerbated by inflation or deflation. Price stability eliminates the real economic costs entailed when inflation exacerbates the distortionary impact of tax and social security systems.
5. Maintaining social cohesion and stability: price stability prevents the considerable and arbitrary redistribution of wealth and income that arises in both inflationary and deflationary environments. An environment of stable prices therefore helps to maintain social cohesion and stability. Several cases in the twentieth century have shown that high rates of inflation or deflation tend to

create social and political instability.



# THE ECB'S MONETARY POLICY STRATEGY

## THE ROLE OF THE ECB'S MONETARY POLICY STRATEGY

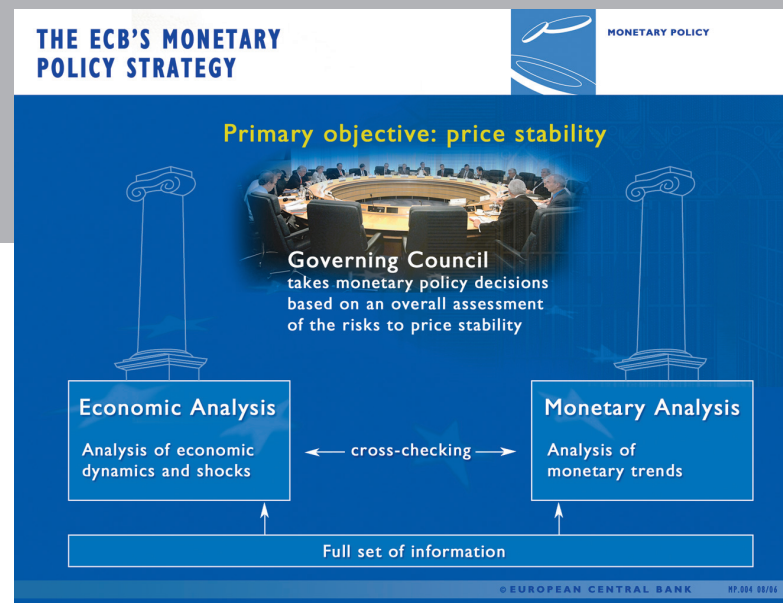
A monetary policy strategy is a coherent and structured description of how monetary policy decisions will be made in order to achieve the objective of the central bank.

It has two important tasks to fulfil. First, by imposing a clear structure on the policy-making process itself, the strategy ensures that the ECB's Governing Council has at its disposal the necessary information and analyses required to take such decisions (internal dimension). Second, it is a vehicle for explaining monetary policy decisions to the public (external dimension). By contributing to the effectiveness of monetary policy, and by signalling the central bank's commitment to price stability, the strategy contributes to the credibility of the ECB in the financial markets.

The main task of the ECB as the heart of the Eurosystem is the conduct of monetary policy in the euro area with the aim to maintain price stability. By setting short-term interest rates, monetary policy influences the economy, and ultimately the price level.

## THE ECB'S MONETARY POLICY STRATEGY

MONETARY POLICY



## TWO-PILLAR APPROACH

To conduct monetary policy in the best possible way, the ECB follows a specific approach in order to determine the nature and the extent of risks to price stability in the euro area. In order to do so, the ECB needs to thoroughly analyse economic and monetary developments. To ensure that no relevant information is overlooked, it has developed the so-called "two-pillar approach".

The ECB's approach to organising, evaluating and cross-checking the information relevant for assessing the risks to price stability is based on two complementary analytical perspectives, referred to as the two "pillars":

- the economic analysis, and
- the monetary analysis.

The economic analysis is aimed at assessing the short to medium-term determinants of price developments, with a focus on real activity and financial conditions in the economy. It takes account of the fact that price developments over those horizons are influenced largely by the interplay of supply and demand in the goods, services and factor markets.

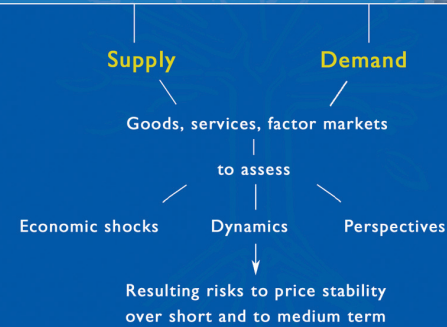
The monetary analysis focuses on a longer-term horizon, exploiting the long-run link between money and prices. The monetary analysis mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications for monetary policy coming from the economic analysis.

The two-pillar approach is designed to ensure that no relevant information is lost in the assessment of the risks to price stability and that appropriate attention is paid to different perspectives and the cross-checking of information in order to come to an overall judgement on the risks to price stability. It represents, and conveys to the public, the notion of diversified analysis and ensures robust decision-making based on different analytical perspectives.

For details about the ECB's monetary policy, see <http://www.ecb.int/mopo>

Alternatively, order a hard copy of the booklet "The monetary policy of the ECB" (edition 2004, 126 pages) from [info@ecb.int](mailto:info@ecb.int).

Analysis of a broad range of economic/financial developments with a view to



## ECONOMIC ANALYSIS



The economic analysis focuses on real activity and financial conditions in the economy. The economic analysis takes account of the fact that price developments over the short and medium term are influenced largely by the interplay of supply and demand in the goods, services and factor markets.

To do so, the ECB regularly reviews

- developments in overall output,
- demand and labour market conditions,
- a broad range of price and cost indicators,
- fiscal policy, and
- the balance of payments for the euro area.

The Eurosystem's staff macroeconomic projection exercises play an important role in the economic analysis. The projections, which are produced under the responsibility of the staff, help to structure and synthesise a large amount of economic data and ensure consistency across different sources of economic evidence. In this respect, they are a key element in sharpening the assessment of economic prospects and the short to medium-term fluctuations of inflation around its trend.

Asset prices and financial yields can be used to derive information about inflation expectations in the financial markets. For example, when buying and selling bonds, financial market participants implicitly express expectations about future developments in interest rates and prices. Using a variety of techniques, the ECB can analyse financial prices to extract the markets' implicit expectations for future price developments.

For more details, see <http://www.ecb.int/mopo/strategy/ecana>



## MONETARY ANALYSIS

Within the set of selected key indicators that it monitors and studies on a regular basis, the ECB assigns a high importance to monetary aggregates. Its monetary analysis relies on the fact that monetary growth and inflation are closely related in the medium to long run, thus underpinning the medium-term orientation of the ECB's monetary policy strategy. The analysis of credit and liquidity conditions enables the ECB to see beyond the transient impact of the various shocks.

In order to signal its commitment to monetary analysis and to provide a benchmark for the assessment of monetary developments, the ECB has announced a reference value for the broad monetary aggregate M3. This reference value refers to the rate of M3 growth that is deemed to be compatible with price stability over the medium term. The reference value therefore represents a "natural" benchmark for analysing the information content of monetary developments in the euro area.

The ECB's monetary analysis assesses on a regular basis the growth of the broad monetary aggregate M3, but also many other monetary and financial variables. For example, developments in the components of M3 (e.g. cash in

circulation, time deposits) are studied because they can offer an insight into the overall changes in M3. In this respect, narrower aggregates such as M1 may contain some information about real activity. Similarly, changes in credit extended to the private sector can be informative about financial conditions and, through the monetary financial institutions (MFI) balance sheet, can provide additional information about money. Such analysis helps to provide both a better insight into the behaviour of M3 in relation to the reference value and a broad picture of the liquidity conditions in the economy and their consequences in terms of risks to price stability.

Finally, the analysis of money and credit may, under certain circumstances, provide early information on developing financial instability. Such information is of relevance for monetary policy because the emergence of financial imbalances or asset price bubbles could have a destabilising effect on activity and, ultimately, prices in the medium term.

### MONETARY AGGREGATES

M1 has been defined as currency in circulation plus overnight deposits. M2 comprises M1 plus deposits with an agreed maturity of up to and including two years and deposits

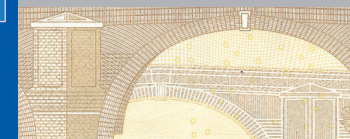
**MONETARY POLICY STRATEGY – MONETARY ANALYSIS**

**MONETARY POLICY**

**Analysis of monetary and credit developments**

- Long-run link between money and prices intact in euro area
- Identification of financial imbalances and/or asset price bubbles
- Money as medium to long-term benchmark

© EUROPEAN CENTRAL BANK 07.004 08/06

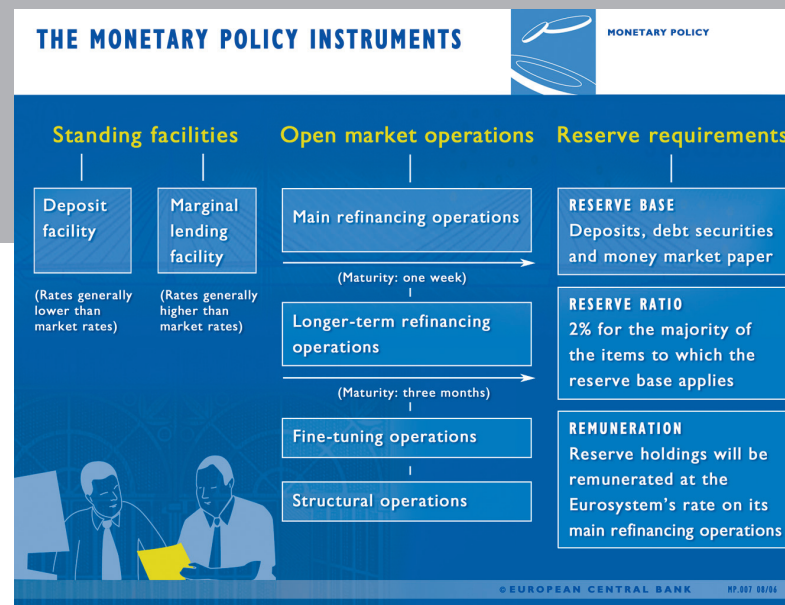


redeemable at notice of up to and including three months. M3 comprises M2 plus repurchase agreements, money market fund shares and units as well as debt securities with a maturity of up to and including two years.

For more details, see <http://www.ecb.int/mopo/strategy/monan>

For definition of the technical terms see the glossary on the ECB's website at <http://www.ecb.int/home/glossary>

# THE MONETARY POLICY INSTRUMENTS



To achieve its primary objective of maintaining price stability, the Eurosystem has at its disposal a set of monetary policy instruments.

## OPEN MARKET OPERATIONS

The most important instrument are the open market operations. They serve

- to steer interest rates,
- to manage the liquidity situation in the money market, and
- to signal the monetary policy stance.

Open market operations can be divided into the following four categories:

1. the main refinancing operations, which are regular liquidity-providing reverse transactions with a weekly frequency and a maturity of one week;
2. the longer-term refinancing operations, which are liquidity-providing reverse transactions with a monthly frequency and a maturity of three months;
3. fine-tuning operations, executed on an ad hoc basis and aimed at managing the liquidity situation in the market

- and at steering interest rates, in particular to smooth the effects of unexpected market liquidity fluctuations on interest rates; and
4. structural operations, carried out through the issuance of debt certificates, reverse transactions and outright transactions.

## STANDING FACILITIES

The Eurosystem also offers standing facilities, which aim to provide and absorb overnight liquidity and set the boundaries for overnight market interest rates.

Two standing facilities are available:

- (i) the marginal lending facility, which allows counterparties (i.e. financial institutions such as banks) to obtain overnight liquidity from the national central banks against eligible assets; and
- (ii) the deposit facility, which can be used by counterparties to make overnight deposits with the national central banks.

## MINIMUM RESERVES

Finally, the Eurosystem requires credit institutions to hold minimum reserves on accounts with the national central banks. The purpose of the minimum reserve system is to stabilise money market interest rates and create (or enlarge) a structural liquidity shortage.

