ECB must apply 'forward guidance' carefully

George Selgin

December 8, 2016

At its policy meeting today, the European Central Bank is expected to announce that it will extend its current quantitative easing program, which involves the monthly purchase of €80 billion of securities, beyond its original March deadline.

Just what form this extension will take is, however, anything but certain. The right choice may help get the Eurozone on the path to full recovery, but the wrong one could find it riding an unpleasant roller coaster.

Although all the touted plans involve a later deadline, that deadline itself is uncertain (though a six-month extension is most likely). While some officials would have the ECB maintain its current level of purchases, others want it to scale back to a lower monthly amount. Still, others favor letting the value of securities purchased each month vary with changing conditions.

Why should such details matter? They matter because the ECB is playing a difficult (and dangerous) game. It wants to reassure its more hawkish critics, including German representatives on its Governing Council who voted against the current purchases, that its quantitative easing deadlines aren't meaningless.

The ECB also wants to give the public some "forward guidance," by committing itself to a definite policy course in the future. Besides countering uncertainty, which itself acts as a drag on investment and growth, an advanced commitment to future easing is intended to enlist the public's help in boosting spending and interest rates by raising today's inflation forecasts.

The danger lies in the fact that central bankers can't know in advance how much easing will be needed, nor for how long, to achieve their targets. Milton Friedman famously warned that "long and variable lags" separate today's monetary policy actions from those actions' future effects on economic activity.

Consequently, central bankers, by placing too much emphasis on current conditions, can end up contributing to economic instability instead of combatting it. When central banks commit to future policy actions in advance, as they do when they make use of forward guidance, they're even more likely to end up regretting their actions.

Recent events illustrate the sort of risks involved. In the U.S., Donald Trump's election, which was itself a surprise, has been followed by an equally surprising rise in equity prices and interest rates. Of course, the Fed could not have anticipated these developments.

Suppose that it had committed itself many months before, based on "forward guidance" grounds, to another round of quantitative easing, and that round had been scheduled to last long after the election. The Fed would then have been compelled either to break its promise, or risk pouring more fuel on an already hot equity market.

The ECB finds itself in precisely the opposite situation. Partly in response to recent European political upheavals, it's poised to extend its commitment to future easing. Who's to say that Europe won't enjoy some more favorable news, political or otherwise, in the coming months?

Does this mean the ECB must either leave the public in the dark about its future actions, or risk destabilizing the Eurozone? It doesn't. There is a way for the ECB, or any other central bank, to provide forward guidance without committing itself to actions that might prove destabilizing.

That solution involves making a firm and credible commitment, not to stick to a particular schedule of securities purchases, but to buy as many securities as it needs to, for as long as it needs to, to achieve a definite policy target.

The target could be 2 percent inflation, or 3 percent nominal GDP growth, or some other economic indicator. As important as having the right target is, it's no less important for the central bank to have an unwavering commitment to achieve it.

Achievement does not mean committing itself to any particular pattern of quantitative easing because no central banker can possibly know in advance what purchases it may take to reach the central bank's target.

Instead of announcing a plan to buy €80 billion, €60 billion, or any definite value of securities each month until September or December, the ECB should announce that it will buy as many (or as few) securities as it takes, for as long as it takes, to get the inflation (or spending) rate to a targeted percent, and to keep it there indefinitely.

George Selgin is the director for the Center of Monetary and Financial Alternatives for The Cato Institute.