

»» The ECB's inflation target: flexible future

No. 297, 4 August 2020

Author: Dr Sebastian Wanke, phone +49 69 7431-9784, sebastian.wanke@kfw.de

The European Central Bank (ECB) is reviewing its monetary policy strategy with a focus on the inflation target – in an environment where price increases are much lower than at the time it set the current target of 'close to, but below, 2%'.

We provide an overview of proposals that have been put forward for designing the ECB's future inflation target. We explore their benefits and drawbacks, their likelihood of adoption and their impacts on monetary policy.

A more flexible target appears to us to be the best solution as it would tolerate inflation rates below 2%. Such a target would be compatible with the ECB's mandate, take into account the current new reality of low inflation, give it wider scope for action and make it easier for the ECB to exit its unconventional monetary policy in the future.

After around 17 years, the ECB is reviewing its strategy

The last time the ECB Governing Council revised its monetary policy strategy was in 2003. A review therefore makes sense – especially since inflation in industrialised countries has decreased noticeably since then. This applies even more to the euro states, not least because of the financial crisis of 2008 and the subsequent euro crisis. The ECB responded to these developments with unprecedented measures. Among others, it lowered its deposit rate into negative territory and launched various asset purchase programmes with the aim of further loosening its monetary policy. Finally, the coronavirus shock prompted the ECB to raise the degree of monetary expansion yet again.

A central bank's monetary policy strategy has many faces. The ECB's review will cover a range of areas that will also include its communication, for example.¹ This paper will only discuss the main object of the review, the inflation target.

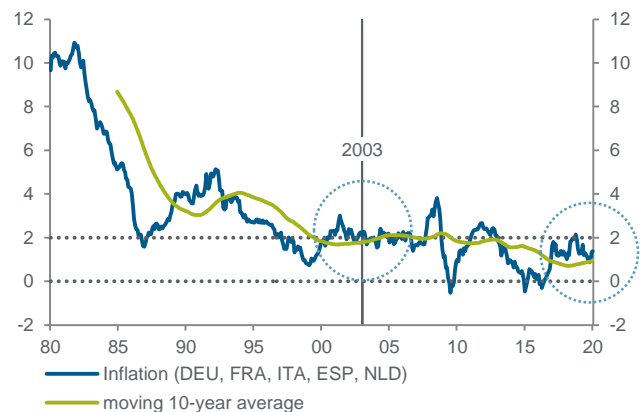
ECB's current inflation target is close to 2%

According to the Treaty on the Functioning of the European Union, the ECB's primary objective is to maintain price stability. The ECB Governing Council initially defined this objective as maintaining the year-on-year increase of the Harmonised Index of Consumer Prices (HICP) below 2%. In May 2003 it then narrowed that definition down to 'below, but close to, 2%'. The main reason given for defining the objective of price stability as being an inflation rate well above 0% is to create a **safety buffer against deflation**. Deflation is defined as an economic downward spiral of falling prices and restrained consumption where businesses and households expect goods and services to be more affordable in future than at present. In such a situation, a drop in demand for its part accelerates price drops and so forth. Recently, these fears

have again become significant against the background of the current recession.

Figure 1: Inflation trend in the euro area since 1980

In per cent and on a monthly basis calculated from annual variation rates of consumer price indexes of the five largest euro countries weighted with their nominal gross domestic products²



Sources: Bloomberg, IMF, KfW Research.

The ECB also indicates that an inflation rate of just under 2% – and hence, well above zero – provides the necessary scope for inflation differences between individual euro member states without requiring countries supposed to become price competitive to necessarily go through a deflationary process. Furthermore, according to the ECB, the inflation rate measured using the HICP slightly exaggerates the actual rates of price increases. Consequently, safety buffers (for preventing price decreases) must be taken into account in setting the inflation target.³

2% is the standard in industrialised countries ...

A glance at other industrialised countries' central banks shows that an inflation target of 2% is the standard, so to speak. The Federal Reserve (USA), the Bank of Japan, the Bank of England, the Bank of Canada, the Swedish Riksbank and Norway's Norges Bank all have a target of 2% (see Table 1). For the sake of completeness, it should be pointed out that the US Federal Reserve has the mandate to not only ensure price stability but also to help achieve the highest possible level of employment through its monetary policy.

And with respect to the inflation targets of the central banks mentioned above, the following particulars also deserve to be mentioned: The Bank of Canada operates with a **target** band of +/-1% set around the key 2% rate. That gives its monetary policy more flexibility. The Reserve Bank of Australia has a similarly flexible inflation target ranging between 2 and 3%. Sweden's Riksbank also operates with a band. However, the Riksbank explicitly refers to this as a **tolerance** band (and

not as a **target** band) in order to signal that consistently achieving 2% is hardly possible in the real world. Nevertheless, its sole objective is 2% – and deviations are merely tolerated but not aimed at. Finally, the Swiss National Bank deviates from the 2% by targeting an ‘inflation rate below 2%’, meaning annual inflation above 0% but not exceeding 2%. That puts its inflation target (slightly) under 2%.

Table 1: Inflation targets of selected industrialised economies

State / currency region	Inflation target
Switzerland	<2%
Euro area	‘below, but close to, +2%’
USA	2%
Japan	2%
United Kingdom	2%
Sweden	2%
Canada	2 +/-1%
Australia	2 to 3%

Sources: www.centralbanknews.info, national central banks, KfW Research.

... but emerging economies have higher inflation targets

The central banks of the large emerging economies all have higher inflation targets (Table 2) because the (average) growth rates of their economies are still much higher than those of industrialised countries and price levels are still significantly lower. As their economies catch up, the rates of price increases there usually turn out higher than in industrialised countries. And indeed, these emerging economies continue to exhibit higher inflation rates.

Table 2: Inflation targets of selected emerging economies

State / currency region	Inflation target
China	around 3%
Russia	4%
India	4 +/-2%
Brazil	4.25 +/-1%
South Africa	3 to 6%

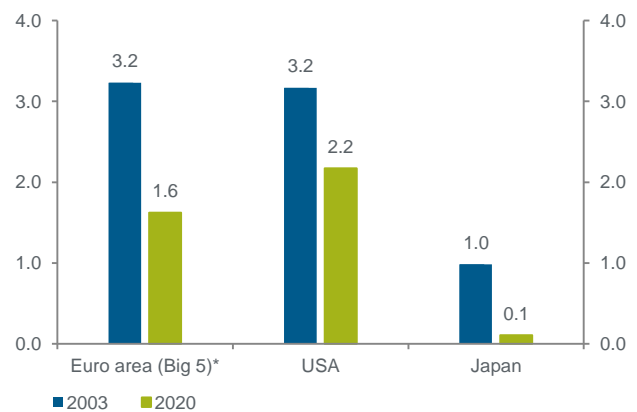
Source: www.centralbanknews.info, KfW Research.

Why (still) exactly 2%?

When looking at the ECB’s strategy review we need to consider above all that the current inflation environment is different to the one in 2003, when the ECB set its current inflation target as ‘below, but close to, 2%’. Figure 2 shows the inflation experiences of the twenty years leading up to 2003 and the twenty years before 2020. When the ECB specified the details of its target in 2003 the annual inflation rates of the five largest economies of today’s euro area had been twice as high on average during the preceding twenty years as they are today. The US and Japan also looked back on more dynamic inflation histories at the time. Industrialised countries’ inflation rates have fallen noticeably over time (see also Figure 1 for the euro area). Globalisation, digitalisation, increasing saturation of markets and demographic change are seen as the main reasons for this.

Figure 2: Inflation experiences in 2003 and 2020

Average monthly inflation rates (compared with the same month in the previous year) of the past 20 years in per cent



* Germany, France, Italy, Spain, the Netherlands⁴

Sources: Bloomberg, IMF, KfW Research.

At the same time, although the inflation rate was lower than desired in the recent past (Figure 1), the economic development was quite satisfactory. Prior to the coronavirus shock, the unemployment rate in the euro area, for example, was 7.3%, the lowest since the introduction of the euro in 1999.

So, could the ECB not simply lower its inflation target in order to more easily free itself from the straitjacket of extreme monetary policy measures (such as negative deposit rates or asset purchases) in the next upswing?

Alternative targets: the discussion mainly revolves around lifting the inflation target – explicitly or implicitly

Interestingly, lowering the inflation target is hardly being debated. Instead, in recent years – coming from the US, where the Federal Reserve is also revising its monetary policy strategy – there have been repeated calls to raise the inflation target.⁵ The aim is to provide additional stimulus for the economy and prices. Ideally, a higher inflation target, e.g. 4%, should first drive up the inflation expectations of economic agents – businesses, consumers, financial market participants. Higher inflation expectations should then positively influence spending decisions. Consumers who anticipate higher prices will bring forward spending from the future. As a result, monetary demand increases, the price-setting scope widens and prices are adjusted upwards. In such a textbook situation, the outcome is indeed more inflation.

As a consequence, employees would demand higher wages and salaries, which would increase employers’ costs. This, in turn, would again encourage price increases.

In the past, that used to result in wage-price spirals which had to be stopped through restrictive monetary policy in order to prevent too much inflation. Today we appear to be far away from such scenarios, which explains why proposals for higher inflation targets are receiving attention. Inflation has lost its terror in industrialised countries and major central banks are now more concerned about deflation.

Besides the idea of raising the inflation target explicitly and permanently, there are proposals to lift it implicitly and possibly only temporarily. These proposals have in common that they in fact apply to multi-year inflation averages and aim to correct missed targets in the future. The most prominent examples are the 'price level target' and the 'nominal gross domestic product (GDP) target'.

The price level target – an implicit target increase

When setting a **price level target**⁶ the central bank determines a path along which a consumer price index is to develop over time. To construct such a path, the central bank must determine a starting point and a desired inflation rate – e.g. 2% in the course of the year (Figure 3).

Figure 3: Hypothetical ECB price target and actual price level development

Assuming an annual target inflation rate of 1.9%; the index is set to 100 for May 2003 (when the ECB specified its current inflation target).



Sources: Bloomberg, ECB, KfW Research.

When the actual inflation rate deviates from the target, a gap opens up between the price level achieved and the price-level path. This gap must then be closed again. If the ECB had pursued a price-level target at a desired inflation rate of close to 2% in the past, for example, the actual price level today would be well below the target (see also Figure 3). For the coming years this would mean that the ECB would now have to achieve an inflation rate above 2% in order to return to the desired level someday. That would imply an even more expansionary policy than today. An even stronger response would be required to bring the less volatile core inflation rate back on course. The latter excludes energy and food prices and is often used as the more precise measure of the underlying inflation trend.

It is questionable whether the economic agents would currently consider achieving a higher inflation target as credible. That would probably not be the case because businesses and private households have already lived through a phase of low inflation for too long. A **credible** inflation target, however, appears to be a fundamental prerequisite for monetary policy to ultimately succeed.

A 'nominal GDP target' would also result in a higher inflation target

The target of a particular **nominal gross domestic product (GDP) level** is similar to the price level target. However, notionally it can be split into two parts: a price component and a 'real GDP' component.

The ECB's primary mandate is to maintain price level stability. According to the EU treaties, however, it also has the task of supporting the remaining economic policy in the euro area. Under this aspect, such a target could be chosen. The drawback would be that GDP data is always published with significant delay and often revised. Furthermore, there is no fixed correlation between the development of GDP and prices, so that when pursuing a nominal GDP target, price level stability is not always ensured under certain conditions. Finally, aspiring to such a target would be a big step and hard to comprehend for many economic agents, particularly since it would be based on a different price index than previously, namely a GDP deflator instead of a consumer price index.

At the same time, the 'nominal GDP target' would come with the same problems as the price level target, if it is to be used – as currently debated – in the coming years to make up for the past years' relatively weak nominal GDP growth. In that case, monetary policy would also have to be loosened even more than has recently been the case already. That, in turn, would also pose the credibility problem mentioned above and jeopardise the success of monetary policy.

Drop to 1½% could be a solution

So why is there hardly any debate about lowering the inflation target? The reason is that many observers assume this would damage confidence in the ECB – after it has spent the last 17 years defending its old target with all conceivable measures, both conventional and unconventional. The standard argument is that lowering the target could be interpreted by the economic agents as capitulation or confession of having pursued a misguided (inflation) target for years. The concern is that the central bank would then completely lose control of inflationary expectations and, hence, inflation itself.

But the same argument could be inverted: Missing the inflation target while staunchly adhering to it for years has probably irritated and unsettled some economic agents. Lowering the target – after a careful analysis – could therefore actually lend the central bank more credibility. After all, such a step would reflect the acknowledgement of new, previously hardly foreseeable realities, in other words, the recognition of the fact that inflation in industrialised countries has fallen noticeably since the ECB's last strategy review.

What else would the ECB have gained from a lower inflation target, besides more credibility regarding its target? If it adjusted its target downward, for example to 1½%, a lower level that would probably continue to offer a sufficient 'deflation buffer', it would have moved it closer to the actually observable inflation rate. Consequently, it could make its monetary policy less expansionary than previously; for example, it

could undertake fewer asset purchases – all else being equal –, end such purchases earlier in a future upturn and then also lift its deposit rate at some earlier point in time. Creating such a (more) realistic exit option should be in the ECB’s own interest, as it is unclear what undesired side-effects the current negative interest environment has – including ultimately on the target of price level stability itself through a conceivable gradual erosion of financial market stability.

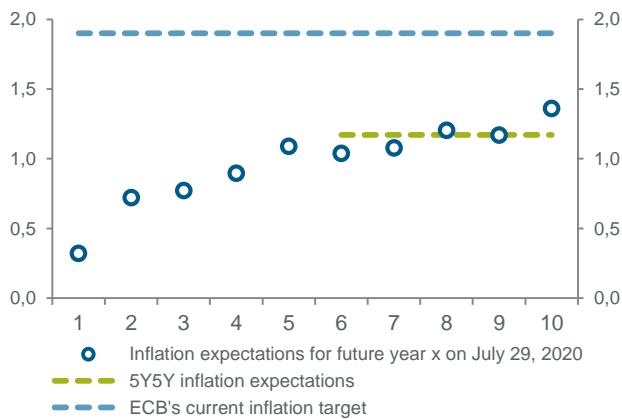
Or a target band for more flexibility?

In order to achieve a similar effect as from simply reducing the target to 1½%, the central bank could set a band of e.g. +/- 0.5% around its current target of close to 2%. That would additionally give it more flexibility when designing its monetary policy.

In arguing against a target band, analysts claim that in the current low inflation environment, economic agents’ inflation expectations would at best move towards the lower edge of the band. But inflation expectations are regarded as key to the actual emergence of inflation. However, in the example explored here, that would be a problem only if a 1½% rise in inflation provided an insufficient safety buffer against deflation and thereby increased deflationary risks noticeably.

Figure 4: Financial market participants’ inflation expectations

Inflation expectations for the next ten years, calculated from ‘inflation swaps’. 5Y5Y inflation expectations refer to the expected average inflation for the five-year period that begins in five years.



Sources: Bloomberg, KfW Research.

There is reason to doubt that this would be the case. Private households, for example, have relatively steady inflation expectations in the euro area, which are furthermore closely guided by the development of the current inflation rate and, therefore, less by the ECB’s actual inflation targeting. Even the financial crisis of 2008/2009 pushed private households’ inflation expectations downward significantly only for a brief period of time. This is reflected in the ECB’s own analyses, which were presented by Benoît Cœuré, then member of the Executive Board, around a year ago. Cœuré also referred to

the fact that the inflation expectations of financial market participants that are identifiable through specific securities (‘inflation swaps’) and were long regarded as highly important, have been distorted downward for years by negative risk premiums.⁷ But even these apparently ‘too low’ inflation expectations are currently not in negative terrain (anymore) for any maturity – despite the coronavirus crisis. Even they can hardly be seen to indicate deflationary fears.

With a target band that also extends beyond 2% – as proposed above – the ECB would also signal that, in times of rising inflation, it would initially allow it to ‘run’ for a while without immediately adopting a more restrictive monetary attitude. In this way, inflation expectations could be lifted at least for the longer term. After all, the ECB so far has not permitted the possibility of an inflation rate above 2% over an extended period of time.

Conclusion

A central bank’s inflation targeting does not follow a law of nature, as illustrated by the different inflation targets set for emerging economies. Nonetheless, the central banks of industrialised countries prefer an inflation rate of (around) 2%. The ECB is now in the process of revising its monetary policy strategy and reviewing its inflation target.

Given that the inflation rate has been significantly lower in the past years than at the time the current ECB target was set (‘below, but close to, 2%’), we believe adjusting this target merits consideration – either in the form of a simple reduction or by introducing a band around the current target. In our view, both measures would increase the ECB’s credibility by acknowledging the structural change in inflation⁸. Such steps could even make the ECB a model for other central banks.

A target band would provide more flexibility and, ideally, even lead to rising inflation expectations and actual inflation increases. Both adjustments under consideration would tend to make it easier for the ECB to exit from its very unconventional current monetary policy at some point in time in the future – because, all else being equal, they would require a less expansionary monetary policy than is currently the case. A possible increase in inflation expectations would have a similar effect. An earlier exit and a resulting general rise in interest rates, for their part, could reduce risks resulting from the ECB’s unconventional measures.

An exit and a gradual normalisation of monetary policy in the euro area would additionally be facilitated by fiscal policy incentives and economic reforms. The ECB has been pointing to this for years without anything decisive happening in the individual euro countries.

The coronavirus shock has now given rise to a noticeably more expansionary fiscal policy which will probably also lead to changes in economic structures and reforms. Furthermore,

the development of the architecture of the euro area appears to have received a boost. Thus, the current crisis seems to offer significant opportunities – perhaps also for the ECB's strategy.

Sign up for our free email newsletter and don't miss out on any KfW Research publications.

Subscribe here

¹ Cf. European Central Bank, ECB launches review of its monetary policy strategy, Press release of 23 January 2020: <https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200123-3b8d9fc08d.en.html>.

² As there is no time series available for the Harmonised Index of Consumer Prices for the euro area reaching back to the 1980s, an approximate inflation rate for the euro area was calculated here. This is done by combining the annual rates of variation of the national consumer price indices of the five largest euro states (based on economic output), collected on a monthly basis, into a single inflation rate. In this calculation the national rates are weighted with the share of the respective country in the overall nominal gross domestic product (GDP) of these five countries – Germany, France, Italy, Spain and the Netherlands. These countries currently generate approx. 85% of the nominal GDP of the whole euro area.

³ Cf. European Central Bank, The definition of price stability: <https://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html>.

⁴ See also footnote 1. The inflation rates shown here were calculated from the national rates of today's five largest euro states using the GDP weighting method.

⁵ Cf. e.g. The Economist: When 2% is not enough – the rich world's central banks need a new target, Edition of 27 August 2016: <https://www.economist.com/leaders/2016/08/27/when-2-is-not-enough>.

⁶ Cf. e.g. Svensson, Lars E.O: Monetary Policy Strategies for the Federal Reserve, International Journal of Central Banking, February 2020, p. 133–193.

⁷ Cf. Cœuré, Benoît: Inflation expectations and the conduct of monetary policy, Speech delivered at an event of the SAFE Policy Center, Frankfurt am Main, 11 July 2019: <https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190711-6dcaf97c01.en.html>.

⁸ This statement is based on the assumption that the so far unprecedented lower inflation of the last approximately twenty years is a structural change that has not generated any additional deflationary risks. It also assumes that the current inflation environment presents an equally low-risk of deflation as the previous one – although no definitive proof of this can be provided. This conclusion may be drawn simply from observing the very positive economic trend up to the outbreak of the coronavirus pandemic, particularly with regard to the development of employment and the unemployment rate.