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Low inflation is good news

By Michael Heise

The prices for crude oil and other commodities are tumbling. This is giving the world economy a welcome shot in the arm. The consumer notices it immediately at the gas pump and when filling his heating tank. But industry also benefits on the cost side, something it will sooner or later be able to pass on to its customers. Especially for commodity and energy-intensive products, such as chemicals or cars, lower prices for energy and commodities percolate down through the whole value chain. And, at the end of the day, this also boosts consumer purchasing power, which is good news indeed.

The ECB should also see things this way. This is not dreaded deflation, causing consumers to stop spending and requiring urgent monetary policy action. The central bank's own analysis provides the first pointer. The price index excluding energy and foodstuffs calculated by the ECB itself currently stands at 0.8%, still well above the zero line denoting deflation. But even that is only part of the picture. Lower production costs mean that industrial prices will fall, or rise more moderately, on a broader front. That is not dangerous deflation either, sufficient to sound the monetary policy alarm bells. Disinflation only gets dangerous when it pushes down expectations of future inflation too sharply. Private households and businesses then start to postpone outlays. But there is no sign of this. Yes, financial market expectations of inflation five years hence have currently dropped to around 1%. But, as we know, this is also in part related to the drop in oil and commodity prices. These won't be heading south forever but will also revert to exerting upward pressure on prices again.

The inflation targeting practiced by central banks is not a straightforward matter. In the short term monetary policy has little influence on price levels – commodity prices, exchange rates, wage costs and state administered prices play a greater role. It is therefore in the interest of central banks not to allow the impression to arise that they can target price levels from month to month. Otherwise any deviation from the reference path (below but close to 2%) is interpreted as a genuine crisis symptom, even if it is caused by, for instance, commodity prices and is desirable in economic policy terms. The animated discussion accompanying the publication of the inflation figures every month illustrates that the focus is not on medium-term trends. But that is the only thing that monetary policy can really influence. Targeting monthly inflation neither makes sense nor is it possible. At the moment we should be glad that inflation is so low. It is no reason to pump yet more liquidity into the market.