Time for monetary policy to get back to normal

by Michael Heise

After years in the doldrums, the eurozone would appear to be back on track to achieve significant growth averaging 1.5% in 2015. With oil prices still relatively low compared with September of last year, and with the external value of the euro, a strong tailwind is sweeping across the entire single currency area - with the exception of Greece. Income growth is particularly pronounced in those countries that have also embarked upon economic policy reforms, such as Ireland, Spain or Portugal. The unconventional policy pursued by the European Central Bank (ECB) has contributed to the weaker euro and, as a result, also to the economic recovery. But is "crisis mode" really still the appropriate course of action?

On the heels of the improved economic data we are now also seeing monetary developments suggesting that the situation is returning to normal. Price developments are particularly significant. The cost of living has been on the rise again for months now, with consumer prices in the eurozone growing at an annualized rate of 2½% since January. The financial markets also expect to see a return to higher consumer prices in the future. These are all welcome developments that nudge the ECB much nearer to its target inflation rate of below, but close to 2%. The credit markets would also appear to be gradually getting back to normal. The downward trend in lending to the corporate sector seems to have come to a halt, lending conditions have become less restrictive and the broadly defined M3 money supply, which served as a key monetary policy indicator back in the days before the crisis, is currently growing at the fastest rate seen in six years. This data has evidently already triggered a change in mindset among investors on the bond markets, with the yield on ten-year German government bonds rising from 0.08% to around 0.7% within the space of only a few days.

So the ECB could gradually start to declare its unconventional anti-deflation policy as a success. In order to prevent any unwelcome surprises and abrupt swings on the financial markets, it should tie the duration and volume of its monthly bond purchases to a simple rule that measures the extent to which inflation has reached the target level. If, for example, an appropriately defined inflation indicator, which takes account of both price trends and expectations, were to rise above the 1% mark, it would be advisable to reduce the monthly purchases. Once the indicator climbs above the 1.5% mark, it would be time to stop the purchases altogether. A clear rule like this should give the financial markets a certain degree of security in terms of assuring them that, while the ECB will not be too hasty in breaking with its ultra-loose monetary policy, it will not be sticking to it for an unreasonably long period of time either. How inflation rates will develop is something that remains to be seen. As things stand, however, we can certainly expect price increases to return to the desired range from as early as the middle of the year. This will be fueled by depreciation effects, the recent rise in oil prices and wage increases in Germany. Once this happens, the first steps towards the normalization of monetary policy should follow in short order.