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Time to rethink inflation targeting

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The financial markets are counting firmly on further monetary policy loosening by the ECB. Even before the meeting on 03 December, German government bonds yields and the euro have slipped sharply. That is probably to the ECB's liking as it strives to boost inflation and get it back to the desired level of below but close to 2%. For some time now the ECB has been way off this mark. Stable prices around the globe and the slide in oil and commodity prices have resulted in very low inflation here in Europe too. That is unproblematic as lower import prices for goods and commodities boost consumer purchasing power and ease the pressure on business costs, allowing profit margins to rise despite stable selling prices.

The target deviations also evident in other countries raise the question to what extent central banks are in fact able to control inflation and, ipso facto, inflation expectations. Generations of economists have learned that inflation is ultimately always a monetary phenomenon. But they were also taught that monetary policy can only influence the price level in the long term and that the relationship is by no means stable but dependent on the behavior of economic agents. For this reason central banks have long been focusing on intermediate targets that are more or less achievable with the instruments to hand – such as the interest rate level or the money supply. It has always been hotly disputed whether monetary policy can reliably control demand, capacity utilization and hence inflation. In open, highly networked economies this question has become even more relevant as international price trends increasingly feed through into domestic developments.

The limitations of monetary policy can also be seen the eurozone. Notwithstanding ultra-expansionary measures, it remained mired in recession for a long spell. Businesses and private households only started to loosen the purse strings once foreign demand began to recover, the reforms for greater competitiveness started to percolate through and progress had been made on the deleveraging front. In the absence of major external shocks, the recovery is set to continue and lending and money supply growth will pick up again. Further bond purchases by the central bank will have little impact. The central banks have already had their finest hour. With radical measures they averted an escalation of the financial and euro debt crisis and a dangerous systemic collapse. But any attempt to fine-tune the economy and inflation is doomed to fail. In the current global environment there is no reason to view stable prices as a threat. Deviations below the 2% figure should be tolerated, just as the overshoots seen in 2011 and 2012 were deemed harmless. The ECB’s inflation norm definition needs to be substantially more flexible.