The case for more flexible inflation targeting

by Michael Heise

The European Central Bank (ECB) aims to lift the increase in consumer prices in the eurozone to a figure below but close to 2%. The ECB itself refers not to an inflation target but to a reference value, but its policy is clearly geared to this target. If the inflation rate is too low, as in May at -0.1% on a year earlier, this justifies the continuation of ultra-loose monetary policy measures.

The concept of inflation targeting is based on macroeconomic models that do not always concur with reality. According to the model, falling interest rates and unlimited central bank liquidity are meant to boost consumption and investment, and thus ultimately stoke more inflation. In reality, however, the transmission channels are extremely flawed. For instance, if households see their retirement savings under threat from zero interest rates and their savings accounts generating no returns whatsoever, they might well save more and not consume more, as we are currently witnessing frequently. And if businesses wish to rein in their debt further given the uncertain backdrop and the large debt burden lingering from the last financial boom, they will not borrow more even if interest rates are low. Abrupt swings in the oil price can also lead to price changes which have nothing to do with monetary policy.

Nor do the pared macro models take account of the many collateral effects that an inflation-targeting policy can have via low or negative interest rates along with the unlimited supply of liquidity. The massive central bank bond purchases have an impact on long-term interest rates and the performance of funded retirement provision, from the private insurance policy to company pensions and the many pension and endowment funds whose returns tumble. And short-term economic models take just as little account of the long-term impact of monetary sustenance for the economy on productivity. Certainly, when there is a threat of acute deflation, such effects must play a subordinate role.

Uncertainty about the transmission channels of monetary policy and behavioral changes on the part of economic agents have frequently undermined simple monetary policy rules in the past. For many years central banks attempted to target the money supply as closely as possible but they repeatedly missed this target as well even though the money supply is far easier for a central bank to control directly than inflation.

What all this boils down to is that the ECB should allow itself more flexibility in its inflation targeting, as the US Federal Reserve does. How could more flexibility be achieved? One option would be to return to the definition of price stability used by the ECB until 2003. Price stability is an inflation rate between 0 and 2%. The advantage of such a definition is evident when, for instance, oil prices plummet – concomitant inflation of zero should not set deflation alarm bells ringing, rather it represents a positive boost to purchasing power which stimulates overall demand. More flexibility could also be gained by communicating the importance attached to several price indicators. Focusing solely on the annual change in consumer prices as the ECB does, and which dominates the public debate, falls well short of requirements. What does it tell us if the annual rate of change in the consumer price index stood at -0.1% in May if at the same time prices rose over April at an annualized rate of 5%?

The paradigm of inflation targeting has now been adopted by central banks around the globe. But it should not be practiced in a rigid way. A situation-dependent and more flexible
definition of price stability would be welcome and the collateral impact on retirement provision, financial stability, bank earnings, the long-term dynamism of the economy and the risk of capital misallocation should all be considered. If acute deflation is present, such collateral effects must play a subordinate role in a central bank’s decision-making. But if the deflationary risks are not plain to see and the impact of monetary policy is questionable, such collateral effects should indeed be taken into account – whatever the stringency of the underlying macro models.