ECONOMIC RESEARCH

Working Paper 180

November 28, 2014

MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

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The ECB inflation benchmark at times of falling commodity prices

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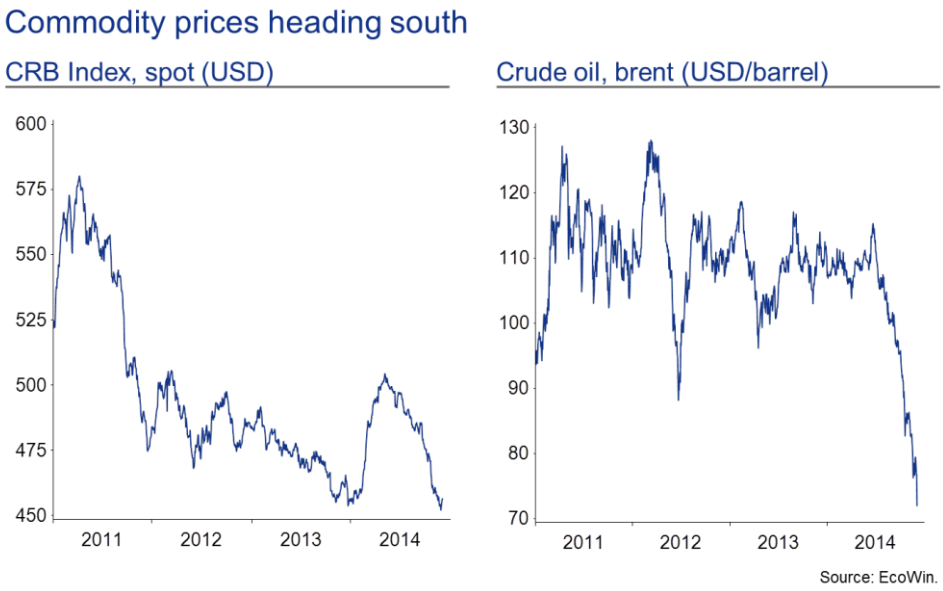
The ECB inflation benchmark at times of falling commodity prices

The financial markets are currently reacting extremely sensitively to changes in the rate of inflation in the euro area, with the view prevailing that every further drop in inflation flags up rising deflation risks. That declining commodity prices actually serve as important economic stimuli tends to be ignored. This means that every decrease in the rate of inflation fuels market expectations of additional monetary easing on the part of the ECB, with the focus of expectations increasingly on unconventional measures such as a comprehensive corporate or even government bond-buying program. At present, however, the ECB is also playing its part in fueling such expectations. At the November 6 press conference, for example, ECB President Draghi stated that the measures most recently adopted by the ECB are also a reaction to the prospect of low inflation. If, as a result of declining commodity prices, inflation forecasts are now being scaled back again and deviations from the 2% mark are widening still further, it is simply logical to expect the ECB to take additional expansionary measures. Given that interest policy measures are exhausted, the only option left is quantitative easing. In our view, the ECB can free itself from this burden of expectation in the medium to long term by correcting its inflation benchmark or, as a minimum, making it more flexible. It simply does not have the tools at its disposal that would quickly push the rate of inflation close to the 2% mark. In the short term it is essential not to fuel the expectations of the markets and instead to pursue a steady course.



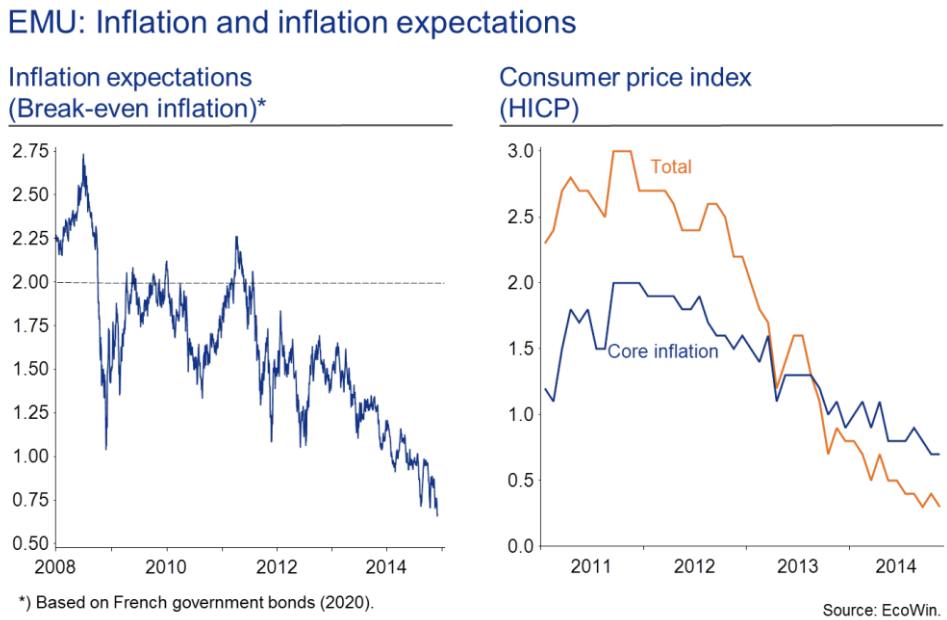
But let us first take a look back. The original definition of price stability was "increase of the harmonized index of consumer prices for the euro area (HICP) of below 2%". This definition did not provide a clear lower threshold, but could be interpreted as a target corridor of 0-2%. In May 2003 the ECB then issued a more concrete definition of price stability. Since then it aims to keep the year-on-year increase in the HICP below, but close to, 2% over the medium term.[1] This meant that the ECB moved from a wide target corridor to a narrowly defined price norm. The ECB emphasized that, at 2%, the upper bound was set significantly above zero in order to incorporate a safety margin against deflation,

[1] European Central Bank, result of the ECB review of its monetary policy strategy, monthly report for June 2003, p. 87 et seq.

but also to take account of potential measurement errors, if prices are not appropriately adjusted to reflect changes in quality. For structural reasons such as catch-up processes regarding the standard of living, there might also be persistent differences in inflation between regions. The desired rate of inflation would need to be sufficiently high to prevent individual regions from entering into phases of a sustained decline in prices. In this respect the focus was primarily on the, at times, high rates of inflation seen in some southern euro area countries with a need to catch up, but in the meantime these developments have come to be regarded as unhealthy and have, by and large, been corrected again. The ECB considers these structural reasons for long-term differences in inflation to be of merely limited significance. It correctly views periods of falling prices in a country mainly as an adjustment of relative prices within the currency union.[2]

From an ECB perspective temporary deviations of the rate of inflation from the price norm are acceptable as long as the expected rate of inflation remains in line with its definition of price stability over the medium term. However, for almost two years now the rate of inflation in the euro area has remained below the ECB's definition of price stability. This is why the ECB emphasizes again and again that its policy of monetary accommodation aims to firmly anchor medium and long-term inflation expectations in line with its goal of reaching rates of inflation below, but close to, 2%. And this is not all: The ECB also links its readiness to deploy additional unconventional monetary policy instruments to the risks it sees in an extended period of low inflation.

From our point of view this nevertheless gives rise to a series of critical questions. Does such a fixed and inflexible norm for the desired rate of inflation really make sense during a time of declining commodity prices? Does a longer phase of low rates of inflation, for which there are good reasons and which have a positive effect, not regularly lead to declining inflation expectations without necessarily having to herald deflation?



[2] ECB, monthly report for June 2003, p. 79.

Inflation expectations can be gleaned from financial market values such as inflation-indexed bonds or from surveys of forecasters such as the Survey of Professional Forecasters. For both players on the financial markets and forecasters, adaptive elements are likely to play a role in shaping expectations - i.e. developments of the recent past are likely to influence expectations. It is a well-known phenomenon that short-term inflation forecasts in particular correlate with the current rate of inflation. The German Institute for Economic Research now concludes in an analysis of the Survey of Professional Forecasters, which contains forecasts of inflation developments over the next one to five years, that, in this medium-term view, too, inflation expectations are increasingly divorcing themselves from the ECB's inflation target.[3] But does it really come as a surprise that inflation forecasts for the next few years are corrected downwards during an extended period of low rates of inflation? Does such a development really signal an increasing risk of deflation and a lack of trust in the Central Bank's ability to prevent this? We should beware of going too far in our interpretation of surveys - even of surveys of professional forecasters. After all they present mere snapshots which may quickly be revised upwards if commodity prices rebound. Similar considerations also apply to inflation expectations derived from financial market products. What is more decisive is the question of whether there are any indications in the real economy of increasing restraint among consumers and investors. At present, in spite of a doubtless merely moderate economic recovery in the euro area, this is certainly not the case. And this also leads one to believe that, as far as consumers are concerned, the perceived rate of inflation is still higher than that recorded by statistical means.

When the ECB set out its price norm more than ten years ago, in view of the experience of previous decades it was by no means a given that inflation could be kept at around or just below 2% in the long term. Given this perspective it was also understandable that price stability was defined, somewhat generously, around 2%. Although the reasons given by the ECB for deviating from zero when defining price stability are correct in principle, the question nevertheless remains whether such a large "safety margin" is really necessary. In our opinion, in today's environment, the answer is no. For instance, statisticians have gone to considerable lengths to prevent the rate of inflation from being overestimated as a result of insufficient capture of quality improvements. For example hedonic quality adjustment methods were introduced in the German statistics for goods such as desktop PCs, notebooks and used cars. Another argument that is often made to suggest that the rate of inflation is overestimated is that the price index is based on a fixed basket of goods which does not take account of shifts due to changes in relative prices. However, in its latest annual report[4] the panel of experts on macroeconomic developments points out that the HICP currently appears rather to underestimate the actual rate of inflation, because the consumption deflator from the national accounts, which takes the budget shift of households into account, shows a markedly lower decline in inflation than the HICP.

As regards the appropriateness of a price target of close to 2% there is another very important aspect: the continuing decline in commodity prices. Since 2011 commodity prices have been heading south on a broad front, give or take some slight fluctuations. For the industrialized nations importing commodities this is tantamount to the effects of an economic stimulus program. For consumers, this means lower fuel or heating oil prices, but industry also enjoys a cost advantage which it will pass on to consumers sooner or later as a result of competition. Lower energy and commodity prices make themselves felt along the entire value chain, resulting in greater purchasing power for consumers,

[3] K. Bernroth, M. Fratscher, P. König and K. Rabe, Inflationserwartungen im Euroraum sind nicht mehr fest verankert – neue Maßnahmen der EZB-Geldpolitik, DIW-Wochenbericht, no.37/2014.
[4] Panel of experts on macroeconomic developments, annual expert opinion 2014/15, item 256.

which is very much desired.

However, this unreservedly positive effect of declining commodity prices on the economy of the euro area makes it all the harder for the ECB to reach its inflation target of just under 2%. If these commodity-related effects were only temporary and merely found expression in the overall consumer prices index, it would be simple to adjust for these effects - for instance by concentrating on the core rate of inflation, the price index excluding energy and unprocessed foodstuffs. At 0.7% the core rate shows a significantly higher rate of increase at present than the overall index (+0.3%), but in our view it, too, is increasingly influenced by the prolonged decline in commodity prices. Passing on the reduction in the cost of production via various trading stages until it makes itself fully felt in consumer goods prices takes time. For this reason alone we need to expect this core rate of inflation to remain well below 2% or even to decline further. This is in no way alarming. The resulting decline in core inflation does not herald dangerous deflation and is therefore no danger signal from a monetary policy point of view. The effects of the drop in commodity prices are likely to put a damper on the overall consumer price index via a series of transfer mechanisms including the wage formation process at least into 2016 - provided commodity prices do not undergo a sustained change.

This is why the European Central Bank should not go all out to push the rate of inflation quickly back towards the 2% mark - it does not have the necessary tools at its disposal in any case. What is needed is a correction of or greater flexibility for the ECB price norm. But what could this look like? Now things get tricky. In view of the current situation of a long-term deviation, any correction of the price norm would be seen by the markets as an admission of failed monetary policy. However, the ECB could resolve to review its monetary policy strategy and reassess the definition of price stability in the process. Such a resolution in itself should be seen by the markets as an indication of a future modification and more flexible use of the definition of price stability. At a more opportune point in time - once the controversial debate about deflation risks has abated - the result of the review could be announced. We believe it would therefore make sense to return to a definition based on a target range which could be 1-2%. Temporary deviations from this range should be tolerated in future as well, provided the expected rate of inflation remains within this range over the medium term. Such a range would present the advantage that small changes in inflation expectations would not lead to exaggerated conclusions, e.g. that the anchor had become unhinged.

An alternative would be to adhere to a price target of just shy of two percent for the long-term (multi-annual) development, but to highlight temporary deviations from these reference values much more clearly and to quantify them. Correspondingly the ECB would need to make it clear to the financial markets that no need to act arises from these deviations. It should also point out that the monthly inflation rates are likely to decline further if oil and commodity prices continue to head south.

The necessary cost and price adjustments in eurozone periphery countries are also exerting downward pressure on the rate of inflation of the union. Taken together both effects currently account for approximately 1 percentage point. This makes it easy to argue that a rate of inflation of around 0.5% in 2014 is no danger signal for a deflationary spiral. The ECB endeavors to take account of such effects in its projections for the coming years. But once the rate drops below two, there will all the same be calls for action. This is something the ECB could and should change.

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