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The Inflation Target in the Euro Area

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Inflation Targeting (IT) is nowadays the basis of the monetary policy framework in most of the advanced and the emerging economies of the world. For many years the inflation target was conceived as the upper bound of permissible inflation rates and Central Banks tried to prevent them to trespass the bound. But after the Great Financial Crisis of 2007-2008 the world monetary scenery changed deeply: nominal interest rates dropped down near to zero, inflation rates began to run well below the targets and the task of Central Banks became to raise them towards the target. A new instrument of policy was employed by Central Banks in order to try to raise inflation rates, namely Quantitative Easing (QE) operations, consisting in massive outright purchases of various kinds of financial assets (mainly national governments bonds) to be held and rolled over at maturity, so producing a structural enlargement of liquidity and expansionary effects throughout the economies. In the Euro Area since 2015 onwards the European Central Bank (ECB), which defined the inflation target as an year—on year increase in the Harmonized Index of Consumer Prices (HICP) of below but close to 2%, launched various Asset Purchasing Programmes (APPs) in order to increase liquidity and raise too low inflation rates; in year 2020 in order to face the heavy economic effects of Covid-19 Pandemic a new great App of 750 billion euro was launched. But QE operations are clumsy and roundabout ways to raise inflation rates because they must first pass through the financial sectors which may be destabilized by the excess of liquidity: anomalous rises in asset prices, debts, financial leverages and derivatives threaten the economic equilibrium and solvency of banks and other financial institutions. Moreover, in the medium and long run, the availability of credit at too low interest rates favours the survival of unprofitable, noncompetitive and even obsolete business enterprises, hindering the birth and growth of new more productive and innovative enterprises.

Keywords: inflation rates, liquidity, quantitative easing, target

Introduction

The need to define a target for monetary policy rises in the years Seventies of the past century, after the collapse of the international system of fixed exchange rates established at the Monetary and Financial Conference of Bretton Woods N. H. in July 1944.

In those years two main variables were chosen to serve as targets of a monetary policy strategy: a relevant money aggregate (M1, M2 or M3) which defined the Monetary Targeting (MT) and the annual rate of increase of consumer prices which formed the basis of a direct Inflation Targeting (IT).[1]

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[1] Bernanke B., Laubach T., Mishkin F. S., and Posen A. S.: Inflation targeting. Princeton University Press, 1999.

With the Monetary Targeting it is assumed that the control of the stock of money is a mean to control also the course of consumer prices: This is the strategy adopted for many years by the Bundesbank, the german Central Bank, but can succeed only if the demand for money is stable. In other Countries the attempt to control the stock of money proved unable to provide an effective control of the course of consumer prices.

The International Spread of Inflation Targeting

After the great inflations of the years 70s and 80s of the past century, mainly due to the great increase of oil prices owing to political and military crises in the Middle East, rules of Inflation Targeting were introduced in the monetary policy framework of some Countries: firstly in New Zealand in 1989, then in Canada in February 1991 and in the United Kingdom in October 1992.[2]

In the following years among the Advanced Economies (AEs)* a 2% inflation target has been set in Sweden, in Japan and in the United States.

In recent years also the number of Emerging Market Economies (EMEs)** which adopted an explicit inflation targeting regime rose considerably , while the number of EMEs using an explicit exchange rate target has declined: Inflation Targeting is now the most common method of fixing targets in major EMEs, following the prevailing practice in the AEs.[3]

The Treaty on European Union at article 127 stated that the main target that must be pursued by the European System of Central Banks (ESCB) is the maintenance of price stability.[4]

In the Euro Area the Governing Council of the European Central Bank (ECB) adopted in 1998 a quantitative definition of price stability stating that price stability—to be maintained over the medium term—shall be defined as an year-on-year (yoy) increase in the Harmonized Index of Consumer Prices (HICP) of *below 2%.*

Instead, the increase in the stock of money, namely M3, was not designed as a target but, at first, only as a "reference value" in the measure of an annual 4.50%, which, even if trespassed, should not require an intervention on the part of the Bank. Later on, this variable was totally dropped from the monetary strategy of the ECB.

A meaningful improvement in the definition of price stability took place in May 2003 when the Governing Council of the ECB defined price stability as a yoy increase of the HICP over the medium term of *below but close to 2%*.

The economic consequences of a positive though low inflation target should be carefully examined.

This new definition implies a tightening of the range of values among which the inflation rates can move: Zero inflation which could have appeared as the most stable rate is no more included in this range.

In practice, the inflation target in the Euro Area can be defined as a price increase of around 2% per year, so that this target is aligned with the inflation targets of a great part of other advanced economies in the world.

Apart some periods of high inflation, a slow inflationary drift has been observed in the past (at least in the long run) in many market economies: by reducing the real burden of public and private debts, as well as real interest rates, it appeared favourable to the debtors' sectors of the economies (including the Governments) and adverse to creditors and savers. It may be questionable if the consequent redistribution of income and wealth can be considered equitable and if it really favours, as someone says, the most dynamic and enterprising elements of the economic systems.

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[2] Fischer S.: Indexing inflation and economic policy. MIT Press, 1986.
[3] Bank for international settlements, June 2019, p. 32.
[4] Svensson L. E. O.: Price stability as a target for monetary policy. NBER Working Paper 1999, 72-76.

Moreover the increase in consumer prices occurring during the time elapsed since the purchase of input goods and services and the sale of output may let appear some nominal profits for business enterprises which do not correspond to an increase of real Gross Domestic Products (GDP) of the Country concerned.

Positive inflation rates imply also the existence of a hidden but iniquitous inflationary tax on fixed income earners, such as dependent workers and pensioners; if this income is not adjusted to the rising price level a certain depressing influence is exerted on the whole economic system.

Inflation Targeting After the Crisis

The economic environment changed markedly in Europe and in the United States after the world Great Financial Crisis (GFC) which broke out in 2007-2008. An age of more stable and even declining consumer prices began with inflation rates occurring often below the target; Central Banks, traditionally devoted to control and fight inflation, were so compelled to accomplish a quite new and opposite task, namely to raise the inflation rates!

Among the means used by Central Banks to raise the inflation rates growing importance assumed in recent years the so-called Quantitative Easing (QE) operations.

These operations are performed through outright purchases by Central Banks of various kinds of financial assets, such as Covered Bonds (CB), Asset Backed Securities (ABS), Government and Corporate Bonds, mainly on secondary markets but sometimes also at issue.

Normally these assets are held by Central Banks until maturity and rolled over at maturity.

QE operations may be considered as instruments of long run monetary policy: Their effects are to raise the degree of liquidity of the economic systems and so to promote, after short or long lags of time, some expansionary movements in the various economic variables starting from the financial sectors where their signaling effect of the expansionary stance of monetary policy influences market expectations of low long-term interest rates. The increase of liquidity and the reduction of the marginal cost of funding for banks and other financial institutions enhance their amount of credit accorded to nonfinancial firms and households and tend to reduce also the level of retail short, medium and long-term interest rates. The increased amount and the reduced cost of credit enhance the demand for investment and consumer goods and services and eventually the level of prices and the inflation rates.

Table 1

Annual % Inflation Rates in the Euro Area—Year 2020

January	+ 1.4
February	+ 1.2
March	+ 0.7
April	+ 0.3
May	+ 0.1
June	+ 0.3
July	+ 0.4
August	- 0.2
September	- 0.3
October	- 0.3

Source: Eurostat.

As instruments of long run monetary policy QE operations are generally programmed in advance for some years to come. Asset Purchasing Programmes (APPs) define the total amount of assets to be purchased in the course of a certain period of time of some years, as well as the amount of assets to be purchased in a single month of the period.

In the Euro Area since July 2019 the annual % inflation rate, as measured by HICP, is running well below the target and so it goes, even with a declining trend, also in year 2020: the inflation rate becomes negative since August 2020.

Somewhere and sometimes a risk of true deflation appeared which was viewed as a considerable danger for the economies, a true economic tailspin and claimed some urging antideflationary action on the part of Governments.

But while in case of deep and prolonged deflation an intervention of Governments (not only through monetary instruments) can be fully justified it may appear questionable an intervention to raise the inflation rates only because they run below the targets.

The general state of the economy should be the main concern of Governments: if the economic system develops with satisfying rates of growth for output, real income and employment, possibly even with effective GDP growing close to potential GDP, an expansionary monetary policy undertaken only because the inflation rate is below the target can scarcely be justified.

While a trial to raise the inflation rate may appear only a clumsy way in order to stimulate a sluggish economy.

A final look must be addressed at the effects of monetary policies of the major AEs (Euro Area, Japan and United States) on the economy of Emerging Countries. The great amount of liquidity spilt over financial markets through Quantitative Easing Programs and Longer Term Refinancing Operations (LTROs)with very low interest rates induces great capital flows toward the EMEs with periodical inflows and outflows of capitals among the Countries, fluctuations in exchange rates, upswings and downswings in the demand for real and financial assets, so raising the level of financial risks, disequilibrium in the balances of payments, the probability of financial and economic crises and increase in the overall degree of uncertainty in the global economy.

Quantitative Easing in the Euro Area

In January 2015 the Governing Council of the ECB announced an Asset Purchasing Programme (APP) to be implemented at least until September 2016. Together with the Asset Backed Securities Purchasing Programme (ABSPP) and the Covered Bonds Purchasing Programme (CBPP3) launched the previous year the Bank foresaw a combined series of monthly asset purchases of 60 billion euro until September 2016 and in any case until a sustained adjustment in the inflation path consistent with the aim of achieving inflation rates below, but close to, 2% over the medium term.

At the onset of the influential pandemic which started in 2020 and in order to face the economic effects thereof, the ECB launched in March 2020 the Pandemic Emergency Purchasing Programme or PEPP for a programmed total value of 750 billion euro. On 4 June 2020 the value of the Programme was increased by 600 billion euro and on 10 December 2020 by 500 billion euro so that the total value reached 1,850 billion euro.

Asset purchases provide stimulus to the economy in a context where key interest rates are at their lowest bound. They further ease monetary and financial conditions making access to finance cheaper for firms and households, tend to support investments and consumption and eventually contribute to a return of inflation rates towards 2%.[5]

The ECB, directly or through the National Central Banks (NCBs) of the Euro Area can buy various types of assets such as securities issued by European supranational Institutions, government bonds issued by national governments of the Euro Area, corporate bonds, asset backed securities and covered bonds. Private assets can be bought also at issue, while public assets such as government bonds can be bought only on secondary markets.

The sellers of these securities with the proceeds of their sales can buy other assets and this portfolio rebalancing raises prices and reduces yields of assets so spreading the effect of ECB purchases over all the market. The reduction of yields encourages banks to increase loans to the real economy and the increased supply of bank lending tends to reduce the cost of borrowing for private firms and households. By reducing funding cost for financial institutions the asset purchases of the ECB indirectly can stimulate domestic production, consumption and investments.[6]

If the sellers of securities to the ECB buy assets expressed in foreign currencies and issued outside the Euro Area these operations can lower the exchange rate of the euro and also this effect may raise eventually a too low inflation rate which may be brought toward the target rate.

Raising the Targets

Recently new proposals have been put forward in some of the AEs to raise the inflation targets above the actual level of around 2% in order to further reducing real interest rates, given the difficulty to reduce nominal interest rates now running near to zero or even negative.

In a paper published by the International Monetary Fund Laurence Ball[7] proposed to raise from 2% to 4% the annual inflation target. He argues that policymakers would do better to target a four percent inflation which would ease the constraints on monetary policy arising from the zero bound on nominal interest rates with the result that economic downturns would be less severe. He thinks that this benefit would come at minimal cost, because four percent inflation does not harm an economy significantly.

In fact, it may be observed that while in recent times some Central Banks have trespassed the zero bound applying even negative nominal interest rates, the foregoing proposal, as well as some other similar proposals, imply a monetary policy still more expansionary than the policies actually conducted and often unable to reach the actual targets. It seems very difficult that a new policy can reach still higher targets, while the aforementioned risks can result furthermore enhanced.

Monetary and Financial Stability: Conflicting Targets?

The stability of prices of consumption goods and services has been until now the fundamental goal of policies inspired by monetary policy frameworks adopting Inflation Targeting: prices of real and financial assets are disregarded. But here we find a true paradox of monetary policy: unlike fiscal measures which act directly on the markets for consumer goods and services, monetary measures must pass through the financial sector in order to reach the real sector of the economy. So they impact, first of all, on financial variables.

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5 European Central Bank. Press Release 22 January 2015.

6 European Central Bank: The transmission of the ECB's recent non-standard monetary policy measures (Economic Bulletin, Issue 7/2015).

7 Laurence Ball: The case for a long-run inflation target of four percent. IMF Working Paper, June 2014, WP/14/92.

Given the more dynamic movements of these variables it is probable that monetary measures designed to stimulate or restrain activities in the real sector of the economy produce much more rapid and wider effects on the financial sector, but often in contradiction with the aims pursued by these measures.

For instance, an increase in short-term interest rates determined by Central Banks in order to curb inflationary pressures on the markets of consumer goods and services may raise the whole range of market interest rates, depress the value of financial assets owned by banks and other financial institutions and raise the burden of their debts, so damaging their economic conditions and sometimes even threatening their solvency. The critical situation of many financial institutions tends to spread its effects on the whole economy and a depressing influence reaches also the sector of nonfinancial firms and households.

Other Measures to Deal With the Financial Sector

Side by side with measures of monetary and fiscal policy, other measures have been recently proposed as parts of a system of governance for the variables of the financial sector, namely a set of micro and macroprudential rules mainly concerning capital, reserve and liquidity requirements and the regulation of market transactions in order to forestall an anomalous growth of financial investments and debts, an increase in nonperforming bank loans (NPLs) and in the level of risks of default for financial institutions.

Macroprudential policies co-operate with traditional monetary policies as integral elements of the wider macro-financial stability framework. They are targeted specifically at addressing risks to financial stability which arise from domestic financial imbalances.

These policies rely on a wide set of instruments which range from tools such as system-wide stress tests, countercyclical capital buffers, provisions to maximum loan-to-value and debt-to-income ratios. In doing so they provide an additional degree of freedom for monetary policy too.[8]

Obviously an expansion or tightening of prudential rules acts, in the medium-long run, as a drive or brake on the potential expansion of credit to nonfinancial firms and households and so affects the growth of the real sector of the economy.

Raising the “Medium Term”

The length of the medium term over which the stability of prices must be maintained has never been defined by the ECB. A lengthening of this term allows obviously a lengthening of the period of time over which the inflation rate can exceed the target.

For this purpose in the United States a meaningful change of strategy has been recently announced by Jerome Powell, Chairman of the Federal Reserve Board: The new strategy could be defined Averaging Inflation Targeting (AIT): the 2% target for the inflation rate should be maintained not continuously, but on the average: an inflation rate higher than 2% could be allowed for some time in order to compensate inflation rates which have been lower than 2%.

The length of the medium term, as well as other topics regarding the revision of the general strategy of monetary policy, are presently under discussion also in the Governing Council and in the Executive Board of the European Central Bank.

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[8] Bank for international settlements: Annual Economic Report, June 2019, p. 44.

Concluding Remarks

After many years the strategy of Inflation Targeting is attracting a renewed interest, though in an economic environment which seems turned upside down since the GFC of 2007-2008.

While traditionally the strategy was conceived for curbing too high inflation rates, induced either by a prolonged rise of demand on the demand side of the market (demand inflation), or by a rise of costs on the supply side (cost inflation), now the problem to face seems to be the presence of too low inflation rates or even deflation, deemed perhaps even more harmful for the economy than high rates.

In a context with very low or even zero or negative nominal interest rates conventional monetary policy cannot exert an effective impact on the course of the economy. More expansionary effects could be produced by nonconventional long run policies which may produce a structural expansion of liquidity, as Quantitative Easing policies implemented through programs of outright purchases of assets by Central Banks planned for some years to come. Outright purchases seem the right instruments in order to achieve long run effects, while Repurchase Agreements (Repos) are the right instruments for ordinary temporary open market operations designed to achieve[9] temporary adjustments of the business cycle.

However, presently, raising too low inflation rates to the actual level of targets around annual 2 percent appears an uneasy task even for ultra-expansionary nonconventional monetary measures undertaken by some Central Banks: so a further raising of targets, as sometimes proposed, could render the task even harder to pursue.

Moreover, Quantitative Easing policies open only roundabout ways for influencing inflation rates because they act directly on variables of the financial sector and only indirectly on variables of the real economy such as inflation rates.

So an expansion of liquidity beyond a certain amount risks firstly to create macroeconomic imbalances in the financial sector, often through excessive growth of financial investments and leverages in bank credit, anomalous growth of derivatives and then to raise global uncertainty, enhancing the risks of financial breakdowns and eventually cause a general crisis also in the real economy.

Furthermore, in the medium and long run the availability of long-term credit at very low interest rates allows the survival of many unprofitable, noncompetitive and even obsolete business enterprises causing a reduction in the general productivity of the economic system and hinders the birth and growth of new more productive and innovative enterprises. It is not surprising if QE operations, while not reaching their goal to raise inflation rates, are consistent in many countries with a state of economic stagnation or very low rates of economic growth.

*According to the classification of the Bank for International Settlements (BIS) the Advanced Economies (AEs) of the world are the following: Australia, Canada, Denmark, the Euro Area, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and United States.

**The Emerging Market Economies (EMEs) are the following: Argentina, Brazil, Chile, China, Chinese Taipei, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, and Turkey.

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[9] European Central Bank: The monetary policy of the ECB, 2011; Id.: The implementation of monetary policy in the euro area, 2008.

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