Why the ECB Needs to Change its Inflation Targeting Strategy

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ECB Listens: Review of Its Monetary Policy Strategy

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Key Lessons Since the Global Financial Crisis

1. *The effective-lower-bound (ELB) constraint on policy interest rates binds more often than expected.*
    - Three reasons:
        - Economy is non-linear ("over the cliff").
        - Shocks from financial disruptions can be huge.
        - Natural rate of interest has fallen

Key Lessons since the Global Financial Crisis

2. *Once ELB constraint occurs, it is much harder to stimulate the economy and raise inflation.*
   - Nonconventional tools less effective than hoped.
   - Key dilemma for central banks in advance countries is that despite heroic measures, inflation remains below 2%

Should the Long-Run Inflation Target be Raised to Above 2%?

- Prominent economists (e.g., Blanchard) suggest target should be raised to something like 4%.

- Pros:
  - With higher target, ELB less likely to occur.
  - With higher target, conventional monetary policy of lowering policy rate can ease more because higher expected inflation allows lower real rate.

Should the Long-Run Inflation Target be Raised to Above 2%?

- Cons:
  - More difficult to stabilize inflation at 4% than 2%.
    - 4% not consistent with Greenspan definition of price stability where inflation is not big factor in economic decisions.
    - Once inflation rises above Greenspan definition at 4%, then why not 6%, or 8% and so on.
    - Exactly what happened in U.S. starting in 60s: View that 4-5% inflation could be tolerated to achieve lower unemployment, with outcome of Great Inflation and high cost to getting inflation back down.
    - One of great successes of central banks over last 20 years is anchoring of inflation expectations around 2%: Raising target to 4% would jeopardize hard-won success of establishing a strong nominal anchor.

Should the Long-Run Inflation Target be Raised to Above 2%?

- Additional Cons:
  - Although raising target might have short-run benefits, it produces distortions in long run.
  - These costs may be small for any given year, but they add up over time.

Should the Long-Run Inflation Target be Raised to Above 2%?

- Bottom line:

  Costs of raising inflation target to 4% outweigh the benefits.

  Answer to question above?

  NO

Should Inflation Target Be Symmetric?

- YES: Do not fall into the Chanel fallacy
- Misses should as often be above as below
- ECB review of monetary policy strategy before global financial crisis (GFC) which set inflation target as "a little below 2%" was a huge mistake
  - Suggests asymmetry and ECB has made serious policy mistakes by not worrying enough about undershoots of 2% target
    - Did not lower policy rate to zero in aftermath of GFC as Fed did and then raised policy rate in April 2011
    - One reason for poorer performance of Eurozone economy

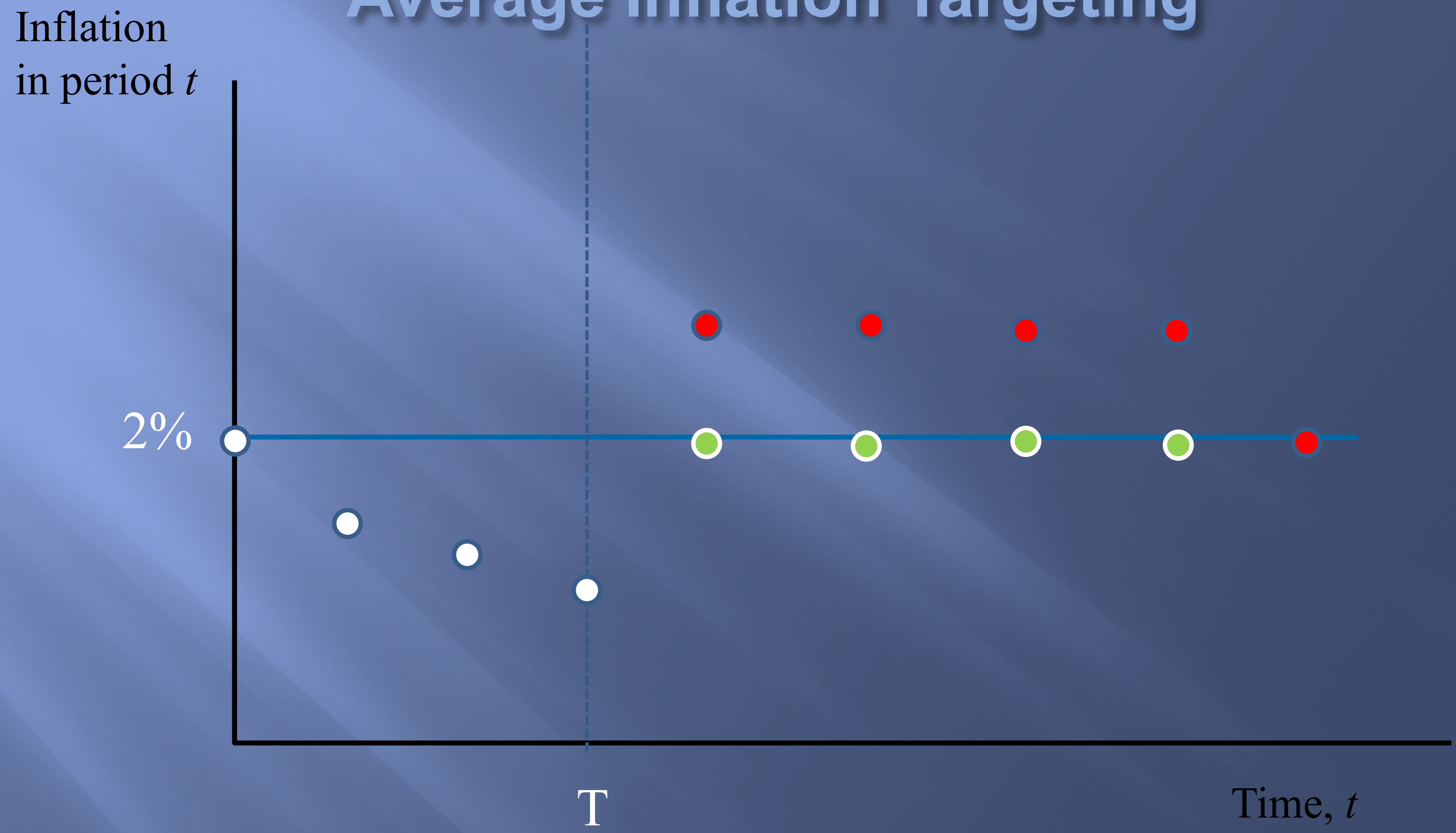
Recommendation 1

- ECB should change inflation target to 2% and emphasize that it is a symmetric target, as Fed has done.

Benefits of Average Inflation Target

- Fed announces it in August 2019
  - Worried that continuing undershooting of 2% inflation target might lead to unanchoring of inflation expectations downward, which is bad in itself, but also makes effective lower bound problem worse
  - ECB has had a similar problem
  - Average inflation targeting fixes this because it does not treat bygones as bygones: i.e., it is history dependent in Woodford's terminology
    - Low inflation in past requires temporary higher inflation
    - If inflation had been running at 1.5% for a several years, then monetary policy would aim for 2.5% for several years.

Average Inflation Targeting



Inflation targeting

Average Inflation targeting

Additional Benefits of Average Inflation Target

- Average inflation target leads to desirable expectation dynamics that leads to less output variance.
  - Negative demand shock results in inflation falling below 2%, which requires raising inflation above 2% temporarily.
  - Expected inflation thus rises above 2%, lowering real interest rate, thereby stimulating economic activity.
  - Average inflation target is automatic stabilizer: negative shock leads to stabilizing expectations
- Even more effective when ELB is binding

Federal Reserve's Average Average Inflation Targeting is Flawed

- Fed is unwilling to specify the period over which the average is calculated
  - If average is over very long period, then in effect the target level is meaningless:
  - Can have inflation in excess of 2% for very long period, so inflation expectations would become unanchored, which would lead to higher inflation and output variability
- Specifying number of periods tells markets how long inflation should be above 2% target

Recommendation 2

- ECB should adopt a 2% average inflation target, where the average is over a specified period, say 5-years, or over the business cycle, or since the ELB started (Bernanke proposal)

- Should clearly communicate that average inflation target is still a commitment to long-run target of 2%, so inflation expectations remain anchored

Average Inflation Targeting has Worked

- Was implemented by the Reserve Bank of Australia in 1995, with 2-3% inflation target "*on average* over the business cycle".
- Economic performance in Australia has been excellent:
  - Average inflation since 1995, when target was adopted has very close to 2.5% midpoint of target range--and no recession for over 25 years until Covid.