Bond Blog

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THE ECB'S NARROWING WINDOW TO TACKLE CHRONICALLY LOW EURO AREA INFLATION

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The European Central Bank's supercharged policy coupled with the euro area's unprecedented fiscal expansion has provided the region with measurable support through the Covid pandemic. Some recent volatility in euro area inflation has prompted speculation about how these policy responses may affect the outlook for inflation. However, when looking through the volatility, the longer-term downward trajectory of inflation remains intact, giving the ECB a narrowing window to build consensus and head off the concerning trend before it becomes even more entrenched.

Measuring inflation involves capturing the general movement in prices, which is a difficult exercise under normal conditions. Yet, attempting to ascertain price movements during a pandemic-induced lockdown can become little more than a guessing game. While the euro area experienced some volatility in inflation over the summer, there are several other short-term, virus-related factors currently affecting inflation readings.

A portion of the recent volatility reflects measurement issues related to the pandemic, including delays in typical summer sales patterns and the simple unavailability of many prices, requiring them to be imputed as part of the inflation data. The pandemic-amplified measurement issues likely say more about shifts in relative prices rather than a general increase in prices.

Furthermore, there are other short-term factors that have recently weighed on inflation, including temporary cuts in value-added taxes by several countries as they looked to stimulate demand, and lower energy prices. Finally, as a large and open economic region, the recent appreciation in the euro amidst reduced fragmentation concerns is expected to continue feeding through to headline inflation with a dampening effect in the coming months (Figure 1).

FIGURE 1: RECENT STRENGTH IN THE EURO HAS DAMPENED INFLATION PRESSURE IN THE SHORT TERM

Source: Bloomberg

When looking through these near-term factors, the inflation concern is not to the upside as some may fear. Rather it is the relatively quick reversion to the existing pattern of weak underlying inflation, which continues a worrying trend that predates the pandemic (Figure 2). Indeed, euro area headline inflation has averaged 1.3% over the last decade, well below the ECB's stated inflation target of below, but close to, 2%. More recently, core inflation reached an all-time low of 0.2% in September.

FIGURE 2: EURO AREA HICP—A DECADE OF A DOWNWARD TRAJECTORY (YEAR-OVER-YEAR % CHANGE)

Source: Haver Analytics

A number of secular factors explain this trend decline, such as demographics, technology and globalisation. The current crisis has added a further dimension to the downward trajectory in the form of significant spare capacity that has opened across Europe as demand fell markedly in early 2020.

The Policy Response

Clearly the ECB's monetary policy response to the coronavirus crisis has been exceptionally supportive. But as recently as late 2019, Governing Council members were divided on the need for additional monetary easing against a backdrop of declining inflation. Quantitative easing looked to have run beyond its political limits and policymakers were either unable, or unwilling, to do more in order to achieve their target. Even then, there was the risk of a downside de-anchoring of inflation. With the ECB's latest staff projections continuing to point to below target inflation, that risk is still very much alive.

At a Crossroads

The ECB's ongoing, but delayed, monetary policy framework review—which is set to be a more comprehensive assessment than the Federal Reserve's recently revised framework—signals a crossroads for the central bank as it provides policymakers with a fresh opportunity to demonstrate its commitment to achieving their price stability mandate. Some members of the Council have been voicing their relatively dovish views. Villeroy de Galhou, Governor of the Bank of France, noted that "we may be prepared to accept inflation above 2% for a period of time without mechanically tightening our monetary stance."[1] Hernandez de Cos, Governor of the Bank of Spain, highlighted that "the degree of tolerance of above inflation deviations is the same as for below-target deviations."[2]

A consensus therefore appears to be emerging in favour of the adoption of a symmetric 2% target with an emphasis on policy flexibility in relation to that target and more prominence placed on the ECB's "second tier" mandate of supporting the general economic policies of the Union, including balanced growth, full employment, and even addressing climate change. The review is not due to conclude until mid-2021, and in the interim, significant challenges around consensus building, particularly with more hawkish members of the Governing Council, need to be overcome.

Whatever the conclusion, the words of ECB policymakers will need to be backed by policy action. Other central banks that have fallen into the disinflationary trap would likely counsel swift action. The ECB faces a narrowing window to act decisively and arrest the decade-long trend of sliding inflation across the euro area before it becomes further entrenched.

[1] SUERF Online Conference, October 14, 2020.

[2] "The Role of the European Central Bank's Monetary Policy in the COVID-19 Crisis," Deusto Business Alumni Meeting, October 1, 2020.

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