

Time to untie the ECB's hands



By Stefan Gerlach/Zurich

The European Central Bank's recent announcement that it will try to end asset purchases by this December means that it has confidence in its ability to achieve price stability.

But those who decided that price stability should be the ECB's single, overriding policy goal may have shot themselves in the foot, not least by denying policymakers much-needed flexibility.

The ECB defines price stability as inflation "below, but close to, 2% over the medium term." That is a lower inflation rate than even the Bundesbank achieved during its celebrated pre-euro history, and it is a tighter target than virtually all other central banks pursue.

For some, too much of a good thing is apparently wonderful.

To be sure, the ECB's definition of price stability was not a problem during the period between the global financial crisis and the adoption of quantitative easing, when inflation was well below 2%. To those who believed that monetary policy had been too tight, the ECB was right to do whatever it could to push inflation up toward the target range.

Yet for those in favor of the ECB's "stability-oriented monetary policy" – a term suggesting that others disregard the risk of monetary instability – the price-stability objective has evidently become too constraining.

From their perspective, asset purchases never should have happened, and interest rates should have been raised long ago, despite the eurozone's too-low rate of inflation.

It is safe to assume that those who hold this view were highly supportive of the ECB's hardline price-stability objective.

They would contend that low interest rates raise financial-stability risks that grow more acute with time.

That is probably true.

And yet it ignores the fact that raising interest rates prematurely can also fuel financial instability.

In any case, the argument is moot, because the ECB's mandate rules out any rate increase that could conflict with price stability.

Of course, those in favor of higher interest rates would counter that inflation of 1% or even less is in fact "close" to 2%, implying that price stability has been achieved and monetary policy can be tightened.

In other words, they do not share the view that "close to 2%" means something in the range of 1.7-1.9%. But this is a pernicious argument.

Running inflation below the level debtors had reason to expect translates into high real interest rates, which in turn risks triggering defaults among borrowers, including mortgagors, firms, and governments.

Undershooting the inflation target is also dangerous because inflation expectations and interest rates will decline over time, which makes it more likely that the ECB will reach the zero lower bound when the next downturn occurs.

It also increases the likelihood that asset purchases will become necessary once again.

Those in favor of a policy tightening would also note that low rates are problematic for savers, insurance companies, and pension funds, whose portfolios often include few equities.

But nowhere does the ECB's mandate say that monetary policy should be set in the interest of savers or the financial industry.

As a practical matter, the ECB's price-stability objective, originally designed to protect the eurozone from Italian-style inflation, has ended up protecting it from German-inspired deflation.

But just because the ECB's mandate has forced it to do the right thing on occasion does not mean that we will be so lucky in the future.

The global financial crisis required advanced economies' central banks to contend with circumstances that those who crafted their mandates scarcely could have imagined.

The fact that things often do not work out as expected is precisely why central banks' objectives should be written to give policymakers flexibility – or poetic license to bend the rules – when extreme events occur.

Otherwise, policymakers will be less effective than they otherwise could be.

Because the ECB's price-stability mandate is legally codified by the Treaty on the Functioning of the European Union, it cannot be altered without a treaty amendment.

But the phrase “below, but close to, 2%” is the ECB's own, and thus can be changed with the stroke of a pen.

As such, the ECB should consider two alterations.

First, it should get rid of the ambiguity inherent in the words “close to,” by setting a point target to provide clarity to the public – and to ECB Governing Council members – about what its monetary policy aims to achieve.

Whether that target is 1.8% or 2%, or whether it is surrounded by a range, is less important.

Second, the ECB must clarify how financial stability and business conditions factor into its policy decisions.

Many have argued that lengthening the policy horizon by precisely defining “the medium term” would give policymakers room to pursue other objectives temporarily.

After all, because financial crises and deep recessions are

deflationary, they, too, jeopardize price stability.

With the ECB finally exiting the last crisis, now is a good time to reflect on what lessons it has (or should have) learned.

The ECB must not delay in positioning itself for the next downturn. – Project Syndicate

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