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ECB Might Overshoot the Inflation Target

The European Central Bank (ECB) has prolonged its large-scale asset purchase programs for public and private bonds in December 2016 until the end of 2017. Otherwise the programs would have expired in March 2017. Due to its strong focus on the inflation target of below, but close to 2 percent, the extension of the asset purchasing programs was expected in case of weak inflation dynamics. Inflation, however, recovered at the end of last year due to normalizing oil prices. Therefore, it came as a surprise that the ECB placed less weight on the normalizing oil prices and inflation expectations in their last monetary policy decision. It seems that the challenges of the last years made the ECB more deflation-averse and probably less inflation-averse.

With oil prices starting to increase again, the threat of deflationary tendencies in the Eurozone is absent now. This assessment is based on the fact that crude oil prices normally lead retail energy prices (see figure). Given that the usual long cycles in crude oil prices also materialize in the coming years, it can be expected that retail energy prices will increase further with the potential to also lift core inflation via second round effects. The rise in the harmonized index of consumer prices of 1.1 percent in December 2016 and the rise in core inflation of 0.9 percent will further strengthen under stabilizing oil prices. This effect is supported by the remarkable decline in unemployment in the Eurozone, especially in the crisis countries. The transition of so many people into work has strengthened aggregate demand enough, so that it is unlikely that deflationary pressures will emerge again in the Eurozone in the coming years. The economic recovery is robust now with real gross domestic product growing with a yearly rate of 1.7 percent in the third quarter of 2016.

The ECB did a lot to stabilize prices as deflationary risks emerged. It intensified its purchasing programs for bonds in several steps. In October 2014 it launched its third covered bond purchase program, in November 2014 it started a purchase program for asset-backed securities, in March 2015 is initiated the public sector purchase program and a purchase program for corporate bonds started in June 2016. Within the framework of active purchase programs, the ECB now holds bonds in the notional amount of 1.3 trillion Euro on its balance sheet. In addition to that, it still holds bonds worth 124.9 billion euros from the already completed purchase programs, like

Consumer price inflation and changes in crude oil prices

In per cent per year

Consumer price inflation (left axis) | Energy and unprocessed food (left axis)
Core inflation rate (left axis) | Change in crude oil prices (right axis)

Sources: Eurostat, Federal Reserve Bank of St. Louis, own calculations

the first two covered bond purchase programs and the securities markets program, which were launched to manage the distress in sovereign debt markets during the height of the Eurozone's banking and sovereign debt crisis.

The aim of these large-scale asset purchases was to reduce financing costs in the euro area and to revive bank lending. The ECB has so far succeeded in cutting financing costs, but lending continues to recover at a slow pace. Although an annual growth rate of the outstanding credit volume of 1.8 per cent in November 2016 already represents an improvement against the negative growth rates in the years 2012 to 2015, the growth rate is still below the average growth rate of 5.4 per cent in the pre-crisis years 2005 and 2006. Money growth has been normalized again since 2015 at 4.5 percent, which is compatible with the objective of monetary stability. However, it should be stressed that monetary growth is not based on credit growth as in the past, but is generated by the ECB's purchases of securities.

For the forecast period until the end of 2017, it is expected that the ECB will keep its key interest rates at the current level despite the decline in cyclical unemployment and the normalization of oil prices and inflation expectations. This is due to the fact that the Governing Council's very strong focus on the inflation target in the medium term has been growing steadily in the last years. The question now is if the ECB sees the risks of a rebound of inflation towards zero as more severe compared to an overshooting of its inflation target. Given the challenges of the last years, the Governing Council might have turned from inflation-averse to deflation-averse. If this is the case it might risk an overshooting of inflation before it tightens monetary policy.

But given that the economic recovery broadens and the drivers of inflation normalize, ultra-low interest rates are hard to justify now. Either its deflation-aversion, the risks that interest rate hikes trigger financial instabilities or political pressures might now determine the ECB's forthcoming policy stance.

The ECB has done a great deal for the recovery of the economy after the financial crisis and the subsequent banking and sovereign debt crisis in the euro area. But the bank now crosses the demarcation line bet-

ween stabilizing and destabilizing the economy with the expansionary monetary policy stance. Now the risks of endangering financial stability seems to increase. The persistent low interest rate environment has significantly squeezed banks interest rate margins and it threatens the business model of life insurances with interest rate guarantees. Given the threats to financial stability it would be problematic if the ECB will maintain its negative deposit rate of -0.4 percent and its main financing rate of 0.0 percent when economic fundamentals improve as they did now.

Monetary policy normalization will be a major challenge for the ECB as it is for the US Federal Reserve Bank (Fed). Since the beginning of its zero interest rate policy, the Fed only managed two rate hikes of 0.25 percent each in 2015 and 2016. The Fed’s cautious approach to monetary policy normalization reveals how difficult it is for central banks to exit the ultra-expansionary monetary policy stance with zero or even negative interest rates and large balance sheets.

The ECB will not be able to get out of the low-interest rate without additional structural reforms in the individual member countries. The high public and private debt levels in many Eurozone countries will restrict the ECB in becoming less expansionary and thereby threaten monetary policy normalization. Because of the high exposures of banks to government bonds, a resurgence of the sovereign debt crisis in the Eurozone will likely lead to a new banking crisis. Given the fact that the vulnerability of European banks to government debt is known, it is a matter of concern that the highly indebted states have not used the low interest rates resulting from the ECB's purchases of bonds to reduce their debt levels. Incentives stand in the way of debt reduction, as governments can prevent an exit from the low-interest rate policy by maintaining high public debt ratios. As the ECB would have to face turmoil in the sovereign debt markets, which would transmit to losses on banks’ bond portfolios and worsen their funding positions in wholesale markets, the ECB is forced to maintain the low interest rate policy. Since governments know this transmission mechanism, the sovereign debt ratio will become policy variable for indebted governments in order to put political pressure on the ECB.

For a normalization of monetary policy a fiscal consolidation is necessary, so that higher central bank rates will not trigger disruptions in sovereign debt markets. But given that politicians will not realize the importance of stable government finances for monetary normalization, we can expect to get a political economy of persistent low interest rates. Therefore, the ECB needs to be the first mover and therefore needs to start to increase interest rates. A main refinancing rate of 0.25 percent and a deposit rate of 0.0 percent should be feasible.