

# Undershooting

After years of inflation below (but not close to) 2%, the ECB redefines its goal

## Banca Promos Investment Banking Desk

**Alessandro Sica**  
Analyst

+39 081 01 70 622  
alessandro.sica@bancapromos.it  
investment.banking@bancapromos.it

The first ECB meeting in 2020 has kicked off a **strategic review of the central bank's activities**, its second in twenty years, after the one completed in 2003.

The wide-ranging policy review will go on until the end of the year, but **the most important topics** -- those relating to the very raison d'être of the European Central Bank, namely the goal of price stability -- **could already be resolved** around the middle of the year, **between June and July**.

### Price stability

The Treaty on the Functioning of the European Union states that **the main aim of the ECB is to ensure price stability** in the euro area. What the TFEU does not clarify is what "price stability" exactly means.

Since 2003, **the Governing Council of the ECB has decided to consider as optimal an annual inflation rate below, but close to, 2%** over the medium-term.

Despite the unprecedented measures put in place by the Frankfurt-based institution to stimulate the European economy (from QE to negative rates, not to mention ultra-cheap long-term loans to the banking system), **inflation in the euro area has remained constantly below 2% since 2013**.

According to the latest Survey of Professional Forecasters carried by the European Central Bank, **the ECB risks missing its primary objective over the next 3 years** (1.2% in 2020, 1.4% in 2021, 1.5% in 2022).

**Inflation rates (%)**



Note: Eurozone, Japan, United Kingdom, United States

Source: Bloomberg

### Next ECB meetings (2020)

**March 12**  
Governing Council MPM

**April 1**  
Governing Council NMPM

**April 2**  
General Council meeting

**April 30**  
Governing Council MPM

**May 20**  
Governing Council NMPM

**June 4**  
Governing Council MPM

**June 24**  
Governing Council NMPM

**June 25**  
General Council meeting

**July 16**  
Governing Council MPM

**July 29**  
Governing Council NMPM

**September 10**  
Governing Council MPM

**September 23**  
Governing Council NMPM

**September 24**  
General Council meeting

**October 7**  
Governing Council NMPM

**October 29**  
Governing Council MPM

**November 18**  
Governing Council NMPM

**December 2**  
Governing Council NMPM

**December 3**  
General Council meeting

**December 10**  
Governing Council MPM

Note:  
MPM = Monetary Policy Meeting  
NMPM = Non-Monetary Policy Meeting

Source: European Central Bank

The ECB's inability to reach its self-imposed inflation target undermines the credibility of the bank in the eyes of investors and consumers. **According to the newly-elected President of the central bank, Christine Lagarde, it's high time to open a debate on the inflation target.**

**Symmetry**

According to some commentators, **the main flaw of the current below-but-close-to-2% goal is** not that it may lead to different possible interpretations, but rather **that it is an asymmetrical target.**

**The remedy** for a goal that considers upward deviations more seriously than downward divergences **would be** rather simple: **to bring it exactly to 2%**, in line with that of all the other major central banks in the world (US Federal Reserve, Bank of England, and Bank of Japan).

**This approach,** not only would have the benefit of clarity, but it **would actually be an upward revision of the goal** compared to the current layout. Apparently, it would be a correction smaller than that hoped for by economists such as Olivier Blanchard -- who advocates a target of 4% -- but still one **able to raise investors' inflation expectations.**

**Range**

On the other hand, according to conservative-leaning policymakers, **low inflation in the euro area** is not a cyclical phenomenon but **reflects** the impact on the European economy of **structural factors** including globalization, digitalization, and population ageing.

Faced with shifts that even a central bank can't counter, **the best option** for the ECB **would simply be to accept the changed scenario and lower its inflation target** in line with the "new normal" of price dynamics. The correction would reduce pressure on the ECB to act with further stimulus measures.

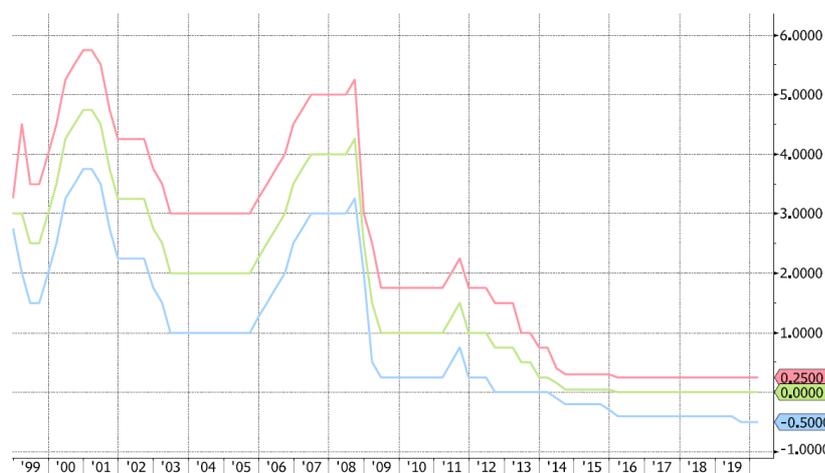
From this point of view, **a possible solution could be to frame the inflation rate within a range,** for example between 1.5% and 2%.

The proposal, which would provide the ECB with more flexibility, would also be a partial return to an earlier age of the institution's history: from 1998 to 2003, the European Central Bank targeted an inflation rate between zero and 2%.

**Isabel Schnabel**  
Member of the Executive Board of the ECB

*"The [inflation] target worked very well in the past but structural changes in the economy justify a careful discussion."*

**Key ECB interest rates (%)**



Note: **Main Refinancing Operations**, **Marginal Lending Facility**, **Deposit Facility**

Source: Bloomberg

## What ECB rate-setters say

### Robert Holzmann

*Governor, Oesterreichische Nationalbank (Austria)*

\* The ECB should lower its target to reflect downward price pressures that are beyond the central bank's control.

### Olli Rehn

*Governor, Suomen Pankki - Finlands Bank (Finland)*

\* The current formulation is skewed in favor of lower inflation rates while the ECB's goal should be flexible and symmetrical.

### Christine Lagarde

*President of the ECB (France)*

\* Christine Lagarde refrained from revealing her own convictions, trying not to preempt the ongoing discussion within the Governing Council.

### François Villeroy de Galhau

*Governor, Banque de France (France)*

\* ECB's target must be symmetric. If it is seen as a ceiling, the central bank has less a chance of meeting it.

### Isabel Schnabel

*Member of the Executive Board of the ECB (Germany)*

\* The ECB should formulate its inflation goal more clearly.

### Jens Weidmann

*President, Deutsche Bundesbank (Germany)*

\* The ECB should simplify its inflation target but avoid any sharp increase in its objective. The central bank needs an understandable, forward-looking, and realistic inflation goal.

### Philip Lane

*Member of the Executive Board of the ECB (Ireland)*

\* ECB's objective should be symmetrical.

### Klaas Knot

*President, De Nederlandsche Bank (Netherlands)*

\* The current concept is not easily communicable. The ECB should accept it could not achieve its inflation aim and change it into a band or allow more time to achieve it.

Sources: Bloomberg, Reuters, Financial Times

## Compromise

Halfway between the proposal of the "hawks" and that of the "doves", the Editorial Board of the Financial Times has outlined **a potential compromise**.

The idea **would be to define a range** for the inflation rate **between 1.5% and 2.5%**. **A longer-term 2% target should then be outlined beside such a medium-term band.**

## HICP, OOH

The **strategy review** launched by the ECB will not only question the quantitative formulation of price stability but **will focus on the very measure of price growth** in the euro area **used by the European Central Bank**: the Harmonized Index of Consumer Prices (HICP).

Calculated by Eurostat, **the index** has at least two flaws:

- It **doesn't account for changes in the costs of homes occupied by their owners** (Owner-Occupied Housing, OOH), unlike what happens in the United States, Japan, but also in Sweden and Norway.
- **The weighting given to changes in rental prices** -- the only housing component in the basket of goods and services used to calculate the index -- **is just 6.5%**. By comparison, the US Bureau of Labor Statistics weights housing above 30% in its own consumer price index.

### Philip Lane

Chief Economist of the ECB

*"Historically, the issue is how do you capture the fact that if you own a home that is partly consumption and it should be in the price index. But partly it is an asset which should not be in the price index."*

To be sure, the issue is not new for the EU statistics agency, which in recent years has tried, in vain, to find a suitable remedy:

- First of all, **housing costs are recorded on a quarterly basis** (with a 3-month lag), i.e. with a much lower frequency than the monthly pace with which the inflation rate is commonly released.
- Secondly, **an increase in the weight of the housing component of the HICP would risk making the reading more volatile**. In the current phase of the economic cycle, the correction would lead to an upward revision of the index for about 20/30bps (according to the estimates of the ECB Chief Economist Philip Lane) but, in a future contraction, the effect would go in the opposite direction. On average, over time, the adjusted inflation figure may therefore not significantly differ from the value that is currently used.

According to sources cited by Reuters, given the complexity of the topic, the tight schedule set by Christine Lagarde, and the confusion that would arise should the ECB start monitoring an inflation measure other than that published by Eurostat, **it is likely that the Governing Council will simply decide to make it clear that it is not satisfied** with the quality of inflation data, thus ramping up its pressure on Eurostat to engineer a fix.

Should this be the case, **any change would take several years to see the light**, well beyond the end of the 1-year strategy review and, according to some ECB watchers, even beyond Christine Lagarde's 8-year mandate.



*The contents of this document and, in particular, the processing of the information collected, is property of Banca Promos SpA. Therefore, without the prior formal consent of Banca Promos, the abovementioned material, in its entirety, can not be copied, downloaded, reproduced, used on other Internet sites, modified, transferred, distributed or communicated to third parties, except for personal use, remaining in any case, forbidden any commercial use. Banca Promos does not carry out portfolio management activities.*

*Banca Promos guarantees that the production, the distribution, and the use of investment research, is only for proprietary and/or treasury trading purposes, adopting the necessary safeguards in order to exclude this activity from the discipline regarding inducement.*

*This information is intended for qualified investors and no commercial agreement is necessary as no direct or indirect compensation has been or will be received in exchange for this service.*

*The information does not represent an investment advisory service and is not intended as an offer or solicitation related to the purchase or the sale of financial instruments.*

*Banca Promos guarantees that the parties carrying out the abovementioned analysis have no interests in the financial instruments processed and, therefore, there are no personal situations of conflict of interest. Banca Promos assumes no responsibility for errors or omissions of any kind about the information published, despite of the carefullness given to the production of the contents.*

*The content of this document excludes the "price sensitive" information character as it is based on qualitative and quantitative information publicly available on the market, and, each consideration expressed by the authors, reflects an independent and personal judgment of the analysed data.*