Economic Research

Economic Insight

ECB – The overdue strategy update

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The ECB is reviewing its monetary policy strategy. An update is overdue as deflation will continue not to be the dominant risk in the future.

The ECB is currently reviewing its monetary policy strategy, which aims to ensure low inflation of 2% in the medium term. President Christine Lagarde, however, has played down the strategy review. That is surprising. After all, the current monetary policy strategy with the possibility of massive government bond purchases is based on the questionable assumption that deflation, i.e. a broad-based fall in consumer prices, is much more dangerous than inflation.

No deflationary downward spiral in the data, …

However, the Bank for International Settlements (BIS) shows that there are no signs of the often mentioned downward spiral of falling prices and consumers' hesitation to spend. During the gold standard in the four decades before the outbreak of the First World War, economic output regularly rose, although consumer prices often fell. It can also be shown for the period since the end of the Second World War that the economy has grown, even if consumer prices had fallen in the meantime. This also applies to Japan, whose per capita income has increased by 0.8 per cent per year since 2000 despite interim drops in consumer prices.

The only counter-example are the years between the First and Second World Wars. During that time, both the economy and the price level collapsed in the USA. This went down in economic history as the Great Depression. However, the fall in consumer prices was not the cause of the economic misery, but a symptom of a deeper problem. Trapped in the gold standard, the US Federal Reserve had failed to provide the faltering banks with the necessary additional liquidity after the Wall Street crash in 1929. As a result, around a third of US banks went bankrupt. The resulting destruction of bank deposits caused the money supply to collapse and pulled down both consumer prices and the output of companies that could no longer obtain credit. The Great Depression was therefore caused by a flawed liquidity policy on the part of the US Federal Reserve and not by falling consumer prices.

… for which there is also no theoretical foundation

There are theoretical reasons why moderately falling consumer prices have usually not been a problem in economic history. For example, consumer prices also fell during the gold standard because companies achieved high productivity gains due to rapid industrialisation. This allowed them to both lower sales prices and increase production. In addition, falling prices increase the purchasing power of money, which boosts consumption. In addition, moderately falling prices and incomes do not make it more difficult to service liabilities if companies are only slightly indebted.

All in all, the ECB's assumption that moderately falling consumer prices are a huge problem is questionable. At least they are no more dangerous than positive inflation, which often weakens the economy. The inflation of the 1970s, for example, unsettled consumers and companies, hampered investment and reduced trend growth of Western economies. The surge in inflation following Russia's attack on Ukraine also caused consumption and the economy to suffer in many countries.

Structural inflation risks dominate

The ECB should also focus less on deflation because structural inflation risks now dominate anyway. For example, Trump's tariffs are fuelling de-globalisation, which lowers productivity and raises prices. Poor demographics and de-carbonisation also point to structurally higher inflation.

What strategy elements the ECB should change

If deflation is not a bigger problem than inflation and inflation is more likely anyway, then the ECB should change its monetary policy strategy in two respects:

- Firstly, it should no longer take more decisive action against low inflation than against high inflation. In particular, the ECB should not buy government bonds on a massive scale and make it easier for finance ministers to run high budget deficits simply because it forecasts inflation below 2%. Other instruments such as multi-year liquidity loans for banks should also not be used on a regular basis. Furthermore, the ECB should raise interest rates more quickly when inflation is rising and should not wait until a previous undershooting of its inflation target has been offset.

- Secondly, the ECB should not base its monetary policy solely on inflation forecasts, but should also take into account credit and money supply aggregates as well as home prices. If these rise sharply, experience shows that speculative bubbles often follow, which eventually burst and cause great damage. In addition, sharp rises in the money supply can sometimes herald a rise in inflation – as seen during the coronavirus pandemic.

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