Has inflation targeting served the Eurosystem well?

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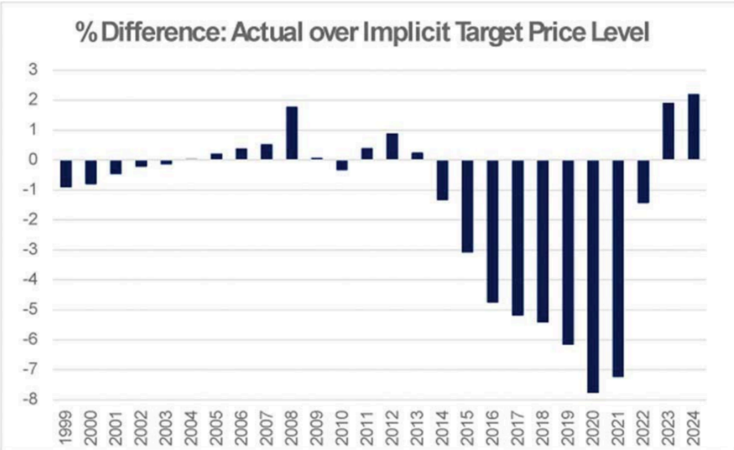
In last week's contribution I argued that the fact that inflation remains a top concern for European citizens despite a steady decline in inflation in the past two years, falling by October 2024 to around the average rate of inflation since the inception of the euro in 1999, suggests that for households the price level may matter more



Furthermore, since the immediate period before the outbreak of Covid to October 2024, the increase in the overall HICP has outstripped the increase in compensation per employee, especially in respect of items that are frequently purchased by citizens, such as food and energy.

These observations raised the question as to whether monetary policy strategy should continue to be based on inflation targeting, which hinges on the principle of letting bygones be bygones with respect to past performance in inflation relative to its target.

In seeking an answer to this question, one would need to assess how actual inflation outcomes since the inception of the euro in 1999, compare with the objective of the ECB of achieving inflation at close to but less than 2% for most of the period, which was subsequently revised, following a monetary policy strategy review in 2021, to a symmetric target of 2%.

For this end, using Eurostat data, the monthly overall HICP index for all euro area countries, was averaged for each year starting since 1998 up to the first 11 months of 2024. This gives the evolution of the actual price level over this 26-year period, driven by actual inflation experienced during such time. Given the ECB's 2% target inflation rate, augmenting the average price level for 1998 by 2% each year thereafter would give the price level for each year if the ECB were to have been perfectly successful in achieving its 2% inflation target each year.

To assess how actual inflation outcomes compare with the objective of the ECB, the difference in the actual price level for each year from the price level augmented by the ECB inflation target of 2% is computed and expressed as a percentage of the implicit price level target. This is shown in the accompanying chart.

The chart shows that since the inception of the euro in 1999 up to 2013 the difference between the actual price level from its implicit target was relatively contained averaging at just 0.1%, as six periods of a negative difference were slightly more than compensated for by nine periods of the actual price level being higher than the implicit target. Moreover, the difference between the actual price level and the implicit target exceeded 1% only once during this period, in 2008, just before the great financial crisis, and during this period the absolute mean difference stood at just 0.5%.

Thus, one can conclude that until 2013, representing the period prior to the sovereign debt crisis in Europe, the inflation targeting regime was quite successful in that the actual price level evolved broadly in line with the implicit price level underpinned by the inflation target of 2%.

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However, with the advent of the sovereign debt crisis in Europe, inflation performance deviated significantly from target, with actual inflation persistently remaining well below 2% for a prolonged period in the face of weak economic activity. Indeed, the chart shows that by 2019, the actual price level was just over 6% lower than the implicit target. The advent of Covid, which brought about a shut down for some time of several activities, made the situation worse, with the actual price level being almost 8% below that of the implicit target, lowering this gap slightly to just over 7% by 2021 as activity started re-opening.

This negative difference in the price level was, however, swiftly reversed with the brutal rise of inflation in 2022, to rates so much higher than the 2% target, such that by 2024 the actual price level was more than 2% higher than the implicit target. More significantly, throughout this 11-year period, the difference has been persistently exceeding 1%, recording an absolute mean difference of 4.4%.

Over the past decade, the inflation targeting regime has not been so successful in achieving its goal. For most of this period the price level stood below the implicit target, which probably reflects why price increases were not the top concern for households during this period. However, over the past three years this has changed rapidly, with the price level turning significantly above that targeted.

Nevertheless, from this analysis one cannot conclude that over the past decade monetary policy or the inflation targeting regime has failed Europe. Clearly inflation outcomes are not solely a product of monetary policy. It is well known that monetary policy is mostly effective to counter demand, but less so supply shocks, where the latter dominated in recent years. Furthermore, when interest rates are at the lower bound, as in the period from mid-2012 to mid-2022, the effectiveness of monetary policy becomes even more limited.

Monetary policy cannot be the only game in town. Fiscal policy and structural reforms are other key ingredients that contribute to actual and potential economic growth, through investment and labour productivity, that have a direct bearing on price pressures. Given the challenges that have been, and still are, confronting Europe, it is doubtful that a change in the monetary policy targeting regime would have alone in the past decade achieved a price level in line with the implicit target.

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