

Economic Briefing

1 October 2020

Will the ECB adopt a Fed-style inflation target?

Yesterday's speech by ECB President Lagarde is interpreted by some market participants as suggesting that the ECB, like the Fed, could adopt an average inflation target. We however believe that the ECB will not formally decide such a strategy in the context of the current review. But in fact, the new ECB strategy will probably have the same result as the Fed strategy – namely a very long phase of loose monetary policy.

What the Fed has decided

The Federal Reserve recently decided to switch to a so-called "flexible average inflation target". The Fed wants to achieve an average inflation rate of 2% in the future. To this end, the Fed will aim for an inflation rate moderately above 2% if inflation has previously been below 2% for a long time. In line with the new strategy, the Fed would not raise its target rate as it did at the end of 2015, when there were signs that the 2 percent target would be reached. It would only move when the previous undershooting of the inflation target was at least partially compensated for by overshooting. All this boils down to the fact that the Fed will leave its target rate at 0.00% - 0.25% for a very long time to come.

What Lagarde really said

In her [speech yesterday](#), ECB President Lagarde spoke about the Fed's new strategy. She said that this strategy could strengthen the effectiveness of monetary policy if the Federal Reserve had reached the effective lower bound of interest rates and could not lower its policy rate further. In this situation, the promise of overshooting the inflation target increases inflation expectations and lowers the real interest rate, thereby boosting the economy. In fact, this sounds like a plea for the ECB to adopt a flexible average inflation target. But Christine Lagarde made an important qualification by pointing out that this strategy only works if it is credible, i.e. people expect higher inflation, which cannot be taken for granted.

According to our interpretation, the ECB President did not commit herself in any way yesterday. Rather, she merely referred to a discussion that the ECB is having as part of its strategy review, which will continue for another year. In contrast to her predecessor Mario Draghi, Christine Lagarde avoids pre-commitments in any case, because this could ruffle feathers in the Governing Council.

The Governing Council of the ECB will probably not formally copy the Fed's strategy...

According to our analysis, the ECB is unlikely to formally adopt an average inflation strategy in the end - partly because the hawks are opposed to this move. Instead, the ECB's new strategy will probably be characterized by two elements:

- Price stability should no longer be defined by the ECB as inflation being close to 2%, but simply 2%. The bar for an exit from the extremely expansionary monetary policy would then be somewhat higher. Moreover, a round figure would be easier to communicate, which is important to Christine Lagarde.
- The ECB is likely to place more emphasis on the symmetry of its monetary policy, i.e. its willingness to take as firm a stand against inflation below 2% as it does against inflation above 2%. In doing so, it wants to make it clearer that it will not tolerate inflation below 2% (e.g. ½%) - unlike in the years before 2003, when its inflation target was not just below 2% but between 0% and 2%.

... but in the end, the result is the same

Even if the ECB may formally decide on a different strategy than the Fed, the material outcome would be the same. This was stressed yesterday by Governing Council member Villeroy de Galhau.

Like the Fed, the ECB will probably stick to its extremely loose monetary policy for many years. This is all the more true as the southern members of the monetary union in particular are heavily indebted and are pushing for a permanently loose monetary policy through their representatives on the ECB's Governing Council.

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