Should the European Central Bank Change Its Two Percent Inflation Ceiling?

The European Central Bank has established an inflation ceiling of two percent. As a result, the central bank in the view of some has been slow to reduce short-term interest rates despite economic sluggishness in many of the larger European economies. Given present conditions, would you keep the targeted ceiling at its current rate? If so, would you have some temporary exceptions such as for special shocks (price of oil, etc.)? To what extent does a lot of the current inflationary pressure relate to structural impediments including labor market rigidities? Is the two percent ceiling a meaningful benchmark in a situation where, despite short-term inflationary pressures, a different policy mix might lead to improvements in the long run for a stronger economy? Or is the current arrangement quite appropriate?

No way!

Leave it as is!

MILTON FRIEDMAN
Nobel Laureate in Economics, 1976
Senior Research Fellow, Hoover Institution

I vote for leaving the ECB's targeted ceiling as it is. Changing the target will be the first step toward altering completely the role and function of the ECB. A bout of inflation now might temporarily reduce unemployment, but unless labor market rigidities are eliminated, it will soon be time to raise the target once again. A slippery slope indeed. Fine-tuning to a fare-thee-well.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Up it to 3 percent.

EDWIN M. TRUMAN
Senior Fellow
Institute for International Economics

The ECB should change its inflation ceiling to 3 percent and adopt inflation targeting with a range of 1–3 percent. The current ECB policy framework has confused the market and policymakers. The ECB has undermined credibility by appropriately, but inelegantly, ignoring the ceiling of 2 percent, defining price stability. Although Euroland desperately needs structural supply-side reforms, its sluggish economic performance is also caused by inadequate demand. Finally, the inflation risk associated with an easier monetary policy is small, and it can easily be reversed; an easier fiscal stance is more difficult to reverse.

Leave it!

HELMUT SCHLESINGER
Former President, Deutsche Bundesbank

My short answer is, "Leave the ECB's target ceiling as it is." My arguments are: It is a ceiling for a medium time horizon, not really a target. In other words, price increases lower than 2 percent annually can be tolerated as well as short-term overshooting. Certainly this is an ambitious target.

One must consider the European Monetary Union is only a creation in the framework of the European Community which is an association of states, not one state; it has not one government but fifteen. And some countries have had a history of high inflation with more than 5 percent inflation in the 1990s, and some have had double-digit rates in the decades before. Therefore, price stability must be a priority target of the ECB.

I feel the critics of the ECB's policy do not really accept differences of monetary policy between the monetary union and on a national basis. They argue as if the euro is an old national currency. But as a currency, it is only four years old and as a common cash, only ten months. It works well in the framework of its task but a fine-tuning of the twelve economies is not its target, and cannot be its target.

Yes, but be precise.

ALLAN H. MELTZER
Allan H. Meltzer University Professor,
Carnegie Mellon University, and Visiting Scholar,
American Enterprise Institute

Of course, the ECB should keep its policy target unchanged. What point would there be to having a rule-like policy and an announced target, if the bank accommodated political pressures and shortcomings as it is now urged to do? While not particularly relevant currently, the ECB, and every other central bank, should be precise about whether its definition of inflation includes one-time shocks to the price level, such as changes in VAT, oil prices, and the productivity level. The big countries in the ECB suffer mainly from mandated structural rigidities, most of them part of the welfare state. People should not expect much from weak European governments. Monetary policy cannot compensate for these real rigidities without inflating. Fortunately, its directors understand that. Perhaps the German, French, and Italian governments will eventually do the same. But don't hold your breath.

Change the ceiling or allow for exceptions.

PETER B. KENEN
Walker Professor of Economics and
International Finance, Princeton University

Keep the target, but be aware of the complexity of the situation

CHARLES P. KINDLEBERGER
Ford International Professor of Economics, Emeritus, Massachusetts Institute of Technology

My short answer is no. Nonetheless, I find it somewhat unsatisfactory to make sharp distinctions between monetary policy, managed by the ECB with only one instrument, the repo interest rate, and economic policy more generally, both monetary and fiscal, which calls for attention to economic shocks such as war, labor unrest affecting wages, changes in foreign supply or demand, significant exchange rate fluxuations, changes in membership in the European Union and the Stability and Growth Pact, or in such a key variables as the Common Agricultural Policy. For the ECB to focus on one goal and one tool, ignoring the complexity inherent in events elsewhere in Europe and the world, runs risks.

Keep it, with no *exception for shocks.*

MANFRED WEBER
General Executive Manager, Association of German Banks

The present inflation target is sufficient to cover different developments in the euro area.

There should be no exceptions for shocks. When they happen, the ECB should explain why the target has been missed. With exception rules, it is difficult to define the end of the extraordinary situation. Presently, the structural rigidities in the labor market lead to higher unemployment, not to inflation.

The current arrangement avoids inflation as well as deflation. Price stability is a prerequisite for growth. The problem is not the interest rate level, but excessive taxes and social contributions and structural rigidities in the labor market.

Allow for exceptions or change the ceiling

BERYL SPRINKEL
Former Chairman of the Council of Economic Advisers and member of President Reagan's cabinet

Keep it to keep credibility.

MANFRED J.M. NEUMANN
Professor of Economics, Institut für Internationale Wirtschaftspolitik, Universität Bonn

I would leave the inflation ceiling at 2 percent to keep credibility. The ceiling is for the medium run, meaning that a temporary deviation of inflation is tolerable. The current inflation level is caused by too-rapid money growth rather than the too-rigid labor market. There will be no lasting improvement in real growth, absent structural reform in the large countries. If the ECB moves first, politics will not deliver structural reform but rely on the hope that monetary policy will work as a quick fix.

Change the ceiling or allow for negative supply shocks.

DR. JOHN MAKIN
Director of Fiscal Policy Studies, American Enterprise Institute

Don't touch the ceiling.

ALAN WALTERS
Vice President
AIG Trading Limited, London

Leave the ECB's targeted ceiling as is. Our problem is not with monetary policy. It lies with structural adjustments.

JEAN GODEAUX
Former Chairman, National Bank of Belgium

Keep it for now to maintain credibility. But consider changes later.

NORBERT WALTER
Deutsche Bank Research

For now, the ECB still has to win credibility as guarantor of price stability. For tactical reasons it should not announce any change of its inflation target of up to 2 percent. It should, however, allow for exceptions now and lower its interest rates by 100 basis points because of the weak economy and a 25–30 percent risk of deflation in 2003.

After the euro gains more credibility and the present recession is over, the ECB should change to a 2 percent +0.75 target instead of today's vague formulation. This is to be preferred not least because ten accession candidates—most of them transition countries—with a bigger need for structural adjustments and ensuing higher price level increases will join soon.

Leave the ECB's targeted ceiling as is.

CEES MAAS
Chief Financial Officer, ING Group

Change the ceiling or allow for exceptions.

PAUL TUDOR JONES
Chairman, Tudor Investment Corp.

Keep the ceiling. The ECB cannot give in to political pressure.

HORST SIEBERT
President, Kiel Institute for World Economics

No, the ECB should not change its targeted ceiling of 2 percent. First, the 2 percent ceiling is a restraint for the medium term only. That means that the actual inflation rate can go beyond the ceiling temporarily as it does in this year (2.2 percent) and did in the two previous years (with 2.3 percent and 2.5 percent). Second, it would be a mistake to assume that monetary easing can solve or even contribute to solving the high structural unemployment in the major continental countries. For this, politicians must be prepared to allow more labor market flexibility. Third, some euro member states exhibit excessive public deficits, among them Portugal and Germany. The stability pact is in doubt. In such a situation, changing the ceiling would mean that the ECB gives in to political pressure. After all, the ECB cannot be like the Fed, since the opponent of the ECB as the guardian of the common money continues to be the fiscal and budgetary policy of sovereign nation states.

The ECB's problem is its mandate.

ROBERT SHAPIRO
Former Undersecretary of Commerce for Economic Affairs

The ECB's problem is its mandate, not its target. As the Fed has demonstrated, it is perfectly possible to promote both price stability and growth. Or perhaps the ECB's problem is cognitive dissonance: With much of the world facing deflationary downwinds and the EU's two largest economies stalled, the specter of rising structural inflation in Europe is ludicrous. Or, just maybe, the ECB's seeming insensitivity to the possibility of a European downturn is designed to turn up the pressure for structural reforms. If that's the Bank's game, it carries measurable risk for the United States as well as Europe.

The ceiling is too low.

JOHN WILLIAMSON
Senior Fellow, Institute for International Economics

The ECB's inflation ceiling of 2 percent for the whole of the euro area is undoubtedly too low. This is because the euro area comprises a number of high-growth peripheral countries as well as the core countries of France, Germany, and Italy. As we have known ever since the seminal articles of Bela Balassa and Paul Samuelson in 1963, fast-growing countries need to inflate more rapidly than slow-growing ones, as measured by any broadly based price index like the CPI, if they are to avoid becoming progressively more competitive in terms of traded goods. A ceiling higher for the whole area than 2 percent is needed to avoid forcing inflation in the core countries down below 1 percent.

Allow for exceptions.

HENRY OWEN
Senior Adviser, Salomon Brothers

I believe that the ECB should keep its targeted interest rate ceiling at its current level, while allowing exceptions for such special shocks as the price of oil. Labor market rigidities are a much more important cause of present economic stagnation in Germany and elsewhere in Europe—much more important than interest rates. Action to reduce these rigidities and to reform taxation so as to increase investment incentives is what is needed. Both these are politically difficult, but they are what really matter.

Leave it. It's a ceiling, not a target.

RICHARD D. ERB
Former Deputy Managing Director, IMF

To date, the ECB in effect has treated its inflation "ceiling" of 2 percent as a target. It has not jammed on the brakes to bring inflation below the "ceiling". Indeed, since May 2001 the ECB has lowered its interest rates in spite of the fact that inflation has remained above 2 percent. The ECB should continue to be so exceptional. By the way, those who would have governments set the inflation target should take another look at how governments and the European Commission have botched the Stability and Growth Pact.

No reason to change.

HERMANN REMSPERGER
Member, Executive Board, Deutsche Bundesbank

First of all, it is important to understand that the ECB does not have a target for the current rate of inflation. According to the definition adopted by the Governing Council, the target is to keep the rate of increase in consumer prices below 2 percent over the medium term. This definition allows the ECB to react flexibly to short-term deviations from the target band. Second, recent research suggests that 2 percent is a reasonable ceiling for the medium-term trend of inflation. Therefore, I do not see any need to change the ECB's present definition of price stability.

Change it.

KARL GEORG ZINN
Professor of Economics, Technical University, Aachen

Economic history tells us that high growth and employment need flexibility of the general price level, i.e., targets of central banks should reflect this empirical wisdom and should not follow an ideological concept. The Maastricht/Amsterdam treaty does not match the disturbing situation of mature economies—a situation that had been forecast by Keynes and other heterodox economists as early as the 1940s. I strongly plead for a change of the inflation ceiling by the ECB.