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ECB at the Crossroads

The ECB has left its policy interest rates unchanged despite inflationary pressures stemming from a strengthened recovery and from rising oil prices. Although the ECB's Governing Council did not discuss a renewal of the long-term refinancing operations, which will expire in 2020, its monetary policy stance is still too accommodative.

At the ECB's latest press conference on the 9th of March, ECB president Mario Draghi casted doubts about the sustainability of the latest inflation surge of up to 2.0 percent in February 2017. Based on its economic and monetary analysis the ECB Governing Council decided to keep the policy interest rates unchanged and the Council confirmed the continuation of the asset purchase programme at the current monthly pace of 80 billion Euro until end of March and at a monthly pace of 60 billion Euro from April to December 2017 (ECB, 2017a).

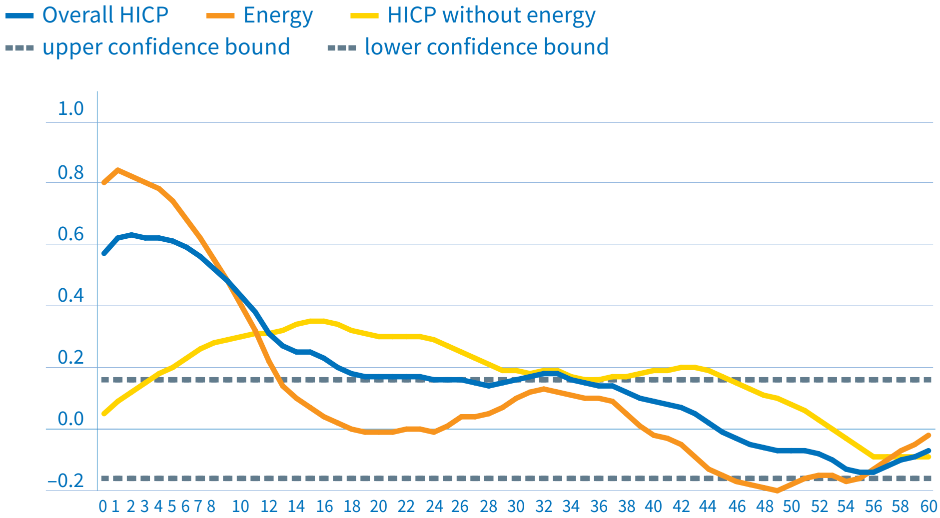
Although the latest inflation rates were between 1 and 2 percent in 8 member countries, higher than 2 percent in 7 member countries and only below 1 percent in 4 member countries in January 2017, the ECB regards these inflation surges to be of a transient nature with no implications for the ECB's medium-term outlook for inflation. Based on the core inflation rate, which does not contain the transient movements of energy prices, the ECB sees the inflation dynamics as too weak for changing its policy interest rates (ECB, 2017a).

Changed economic environment

Evaluating monetary policy based on the current inflation rate alone is far from sufficient to evaluate the current situation, since such an analysis would neglect that the economic environment has changed since the beginning of the year.

The ECB's main challenges in the past years – weak inflation dynamics with the risk of deflation – were based on a combination of a negative demand shock and a positive supply shock. The negative demand shock reduced price and growth dynamics and high unemployment and high debt levels have constraint the recovery of demand for a long time. The positive supply shock was based on declining oil prices, which aggravated the deflationary pressures, but which eased spending by a reduction in the costs of energy and energy-related goods and services. Given the high indebtness, the oil price shock's impact on

Correlation analysis



X-axis: lag of oil price change in months
Y-axis: correlation coefficient between inflation and past oil price changes

Sources: Eurostat, own calculations

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prices was large, while its impact on spending was small, since it was more important for firms and households to reduce their debt levels while energy costs were low.

Now the tide has turned. Aggregate demand has started to recover. Unemployment has declined in many member countries and better job prospects have enabled spending. The accommodative monetary policy stance has eased credit conditions and as economic growth is expected to strengthen also firms' demand for loans recovered. Although investment is still weak, consumption is strengthening. But the world economy is currently also facing a positive oil price shock, i.e. a shock that increases prices, but lowers growth and thereby poses risks to the economic recovery of the Eurozone.

While a central bank's response to a positive aggregate demand shock is straightforward – it has to lift interest rates to suppress aggregate demand, – a positive aggregate supply shock confronts a central bank with a trade-off: it can either suppress the inflationary pressures by lifting interest rates and thereby risking growth to slow down, or it can stay neutral or accommodative in order to spur growth, while risking that inflation will skyrocket. This is the situation, the ECB is facing now.

Oil prices affect core inflation

The ECB's decision to stick to its accommodative monetary policy stance would be sensible only if the inflationary dynamics were of a transitory nature and oil prices dynamics would not translate into core inflation. But if the ECB stays accommodative although the recent oil price hikes translate into higher core inflation with a lag, the ECB will have to face higher long-term inflation.

We tackle this hypotheses in our correlation analysis (figure). It shows the correlation between the current inflation rate and oil prices changes lagged up to 60 months. We find statistically significant positive correlations between inflation and lagged oil price changes for up to 18 months, which reveals the longer term influence of oil price shocks on inflation. These correlations range from 0.62 for one month lagged oil price changes to 0.18 for 18 month lagged oil price changes.

Our analysis also shows that the correlations with lagged oil price changes are larger for energy prices, but only significant up to lag 12. This means that energy prices will react immediately to rising oil prices, but this effect is more of a transitory nature as highlighted by the ECB.

But more important for the evaluation of monetary policy is how past oil price changes affect core inflation. We find that the correlations are smaller, but of a longer term nature. The correlation becomes statistically significant after three months, it increases to 0.35 at lag 15, it then declines and stays significant until lag 45, i.e. that there is a statistically significant positive correlation between current oil price changes and core inflation in more than 3.5 years. Given that, the current hikes in oil prices should not be regarded as a transitory problem for monetary policy as the ECB highlighted, but as factors that can lift core inflation over a longer time horizon.

ECB is too accommodative

Given the negative policy interest rate and the still enduring large-scale asset purchases, the ECB's monetary policy stance seems to be too accommodative and given the recent surge in oil prices it seems that the ECB's decision to leave both instruments unchanged up to the end of the year or longer will cause inflation to overshoot.

But one has to take Mario Draghi's comment on the targeted long-term refinancing operations (TLTRO) also into account. During the Q&A session after the introductory statement, Draghi mentioned that the TLTROs of 506.7 billion Euro will expire by 2020. The TLTROs were aimed to "reinforce the ECB's current accommodative monetary policy stance" (ECB, 2017b). Remarkable was, that Draghi mentioned that there was no discussion on the ECB council on having another TLTRO. Moreover, he added, that the council does not anticipate to reduce rates further ECB (2017a). The expiration of the LTROs will translate into a balance sheet reduction, e.g. measured from the value at the end of 2016 of 3662.9 billion Euro by 13.8 percent.

Although this is a gradual adjustment over four years, the ECB' policy interest rates were too low given the new economic situation of strengthening recovery, declining unemployment and increasing oil prices. Part of the analysis should also be the risk assessment of a prolonged period of extremely low interest rates. That low rates have squeezed banks' and life insurers' profits endangers these business models which are important for the allocation of household savings. Therefore, the next step towards policy normalization should be the lift-off from the negative interest rate domain back into the positive domain. In addition to that, it would be unnecessary and even harmful if the ECB would prolong its asset purchase program. It should at best end in December 2017 or be phased out earlier.

References

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