ECB Inflation Targeting: They Have No Choice

The European Central Bank (ECB) came in for some criticism from the usually-reliable Dean Baker today. Baker says the ECB inflation target of 2% is too low and that they should try for at least 4% (Mr. Baker's suggestion, not mine). In principle, I agree with him. Given the generally rigid structure of European labor markets, the only way to get the real wage to fall is via inflation. (Even that won't be successful to the extent that the various unions have included cost-of-living-adjustment (COLA) clauses in their contracts.) But principle collides with practice in this case. There'a a major problem with disparaging ECB inflation targeting: they have no choice. The Treaty that established the ECB mandates that the bank pursue price stability. That means zero inflation. Here's what the ECB has to say about the situation:

"Although the EC Treaty clearly establishes maintaining price stability as the primary objective of the ECB, it does not define what "price stability" actually means.
…
In October 1998 the Governing Council of the ECB defined price stability as 'a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%' and added that price stability 'was to be maintained over the medium term.' The Governing Council confirmed this definition in May 2003 following a thorough evaluation of the ECB's monetary policy strategy. On that occasion, the Governing Council clarified that 'in the pursuit of price stability, it aims to maintain inflation rates below but close to 2% over the medium term'." (page 80)

Technically the ECB is violating their mandate. To economists, the meaning of the phrase "price stability" is clear: zero inflation. We can argue and disagree about whether that is a reasonable goal – Mr. Baker and I agree that it is not reasonable – but the ECB really doesn't have much of a choice. As it is they're a little way out on a fragile limb with their current inflation target.