ANALYSIS

ECB revised its monetary policy strategy – what's changed?

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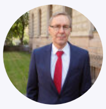

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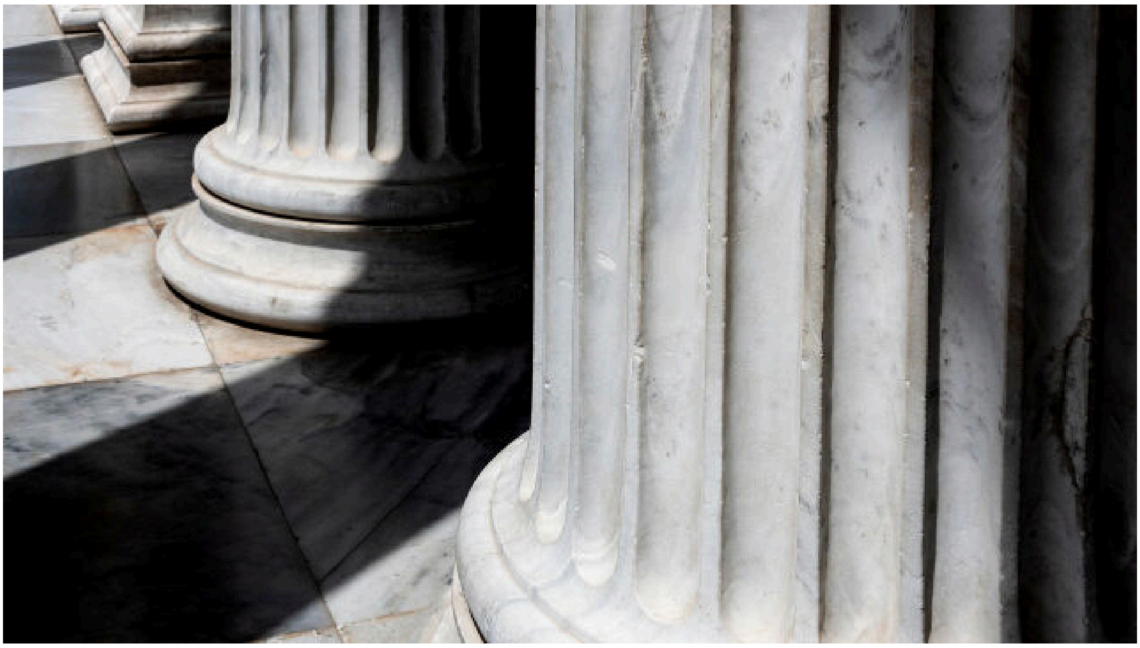
The ECB's revised monetary policy strategy has now been adopted. The new 2% inflation target is clear and unambiguous. The target is symmetric, meaning both negative and positive deviations of inflation from the target are considered as equally undesirable. Commitment to the symmetric inflation target requires especially forceful or persistent monetary policy measures when interest rates are close to their effective lower bound. This may imply a transitory period in which inflation is moderately above target. A medium-term orientation with the inflation target also allows the ECB to emphasise sustainable growth and full employment in its decision-making. In its monetary policy, the ECB also takes into account environmental sustainability, in line with the new climate-related action plan.



The monetary policy strategy of the European Central Bank (ECB) outlines how the ECB maintains price stability in the euro area and what objectives it sets for its monetary policy. The strategy also provides a coherent analytical framework for monetary policy decision-making and communication. The ECB's monetary policy strategy is based on the Treaty on European Union and the mandate conferred by it to the ECB. It is within this mandate that the Governing Council of the ECB determines its strategy.

The ECB's first monetary policy strategy was adopted in 1988, when the European Central Bank began its operations, but it was clarified already in 2003. The strategy contained three key elements: 1) a quantitative definition of price stability; 2) a time frame for achieving price stability; and 3) a two-pillar strategy for analysing risks to price stability.

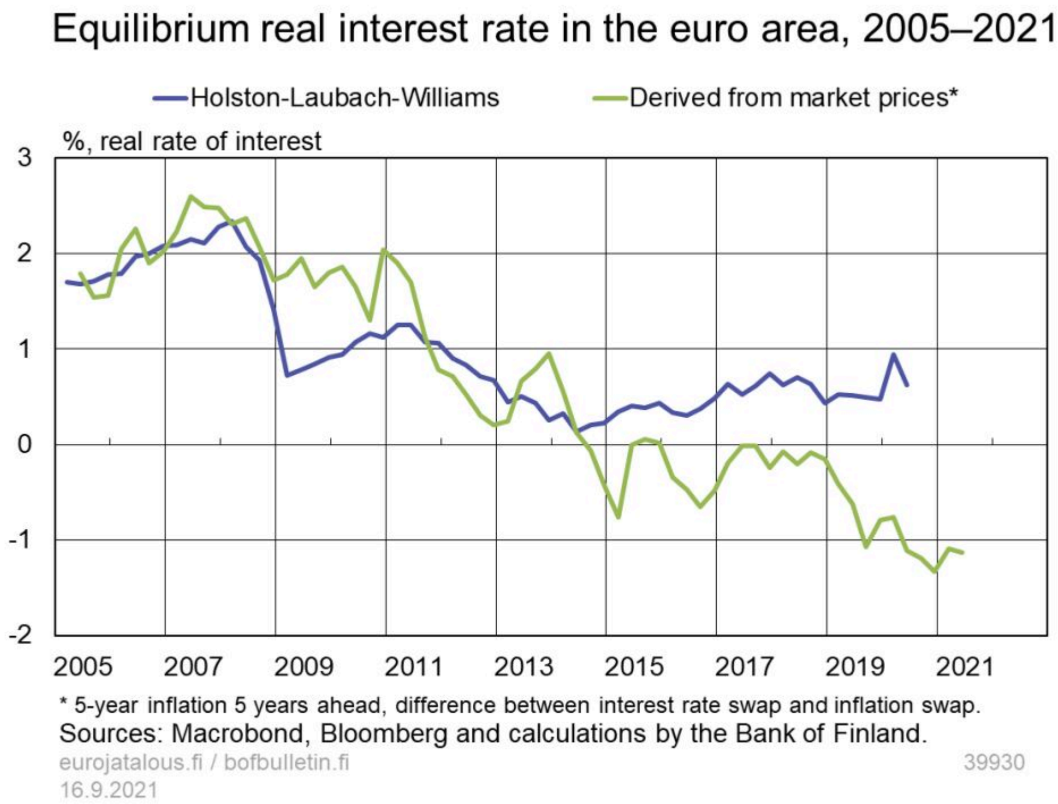
At that time, the strategy made a distinction between the short and medium term and the long term. Monetary policy decisions were to be based, on one hand, on an analysis focusing on the short-term demand and supply factors in the economy and, on the other hand, on a monetary analysis focusing especially on developments in monetary and credit aggregates. The purpose was to provide information on short and longer-term inflationary pressures in the euro area for the calibration of the monetary policy stance.

The Governing Council published its new monetary policy strategy and the related principles on 8 July 2021. The new strategy is the result of a thorough review of the economic environment for monetary policy, which was launched in January 2020. It draws on an extensive analysis by Eurosystem experts, including important contributions by the Bank of Finland.[1] In connection with the strategy review, a number of listening events and seminars were organised for the academia, civil society organisations, the general public as well as national parliaments and the European Parliament. The ECB intends to continue with similar outreach events to improve its interaction with the public.

A stable and predictable outlook for prices and hence public confidence in the preservation of purchasing power are key prerequisites for sustainable economic growth and high employment. The strategy is based on the premise that, at the level of the economy as a whole, price stability, balanced growth and high employment are mutually consistent objectives. Successful monetary policy contributes to ensuring that the central bank's monetary policy maintains price stability and promotes citizens' welfare in the optimal way. Targeted monetary-policy communication can significantly reduce the uncertainty associated with monetary policy and improve citizens' and market participants' understanding of how monetary policy decisions relate to actual and expected economic developments.

A key motivation for the strategy review was that the operating environment for monetary policy has changed since the Governing Council previously revisited its strategy in 2003. The long-term natural rate of interest, or the equilibrium real interest rate has declined for structural reasons in the euro area and also globally (Chart 1).[2] One of the major structural factors is demographic change. Population ageing has boosted savings and liquidity demand and lowered the level of interest rates. It may also have slowed economic growth, through lower productivity and declining investment. At the same time, demand for loans has decreased and interest rates have trended downward.

Chart 1.



As a result of the global financial crisis and the euro area sovereign debt crisis, inflation has also slowed in the euro area. Globalisation and digital technologies have, in turn, influenced the composition of goods and services production, the labour market and possibly also inflation over the longer term. Inflation has also been affected by demographic factors, but researchers disagree about the direction of the effects of shrinking population and demographic change.[3] In general, however, economists consider demographic factors deflationary due to the related contraction in aggregate demand. Financing structures have also experienced substantial changes since the financial crisis, for example owing to the rise in non-bank financial intermediation.

These changes have reduced the possibilities for the ECB and other central banks to respond to economic downturns by easing monetary policy using conventional instruments. In economics literature, this phenomenon is known as the zero (or effective) lower bound constraint on monetary policy.[4]

Inflation has long been below the ECB's price stability target. The period of low inflation and negative monetary policy rates has lasted over a decade. The persistent slower-than-targeted rise in prices has been reflected in inflation expectations and has lowered them substantially. As a consequence, inflation expectations have become less well anchored to the ECB's price stability target.[5]

Threats to environmental sustainability have also become a major global and political challenge. Addressing climate change is now also one of the European Union's policy priorities. While governments and parliaments have the primary responsibility to act on climate change, within its mandate, the ECB recognises the need to incorporate more climate considerations into its monetary policy framework.[6]

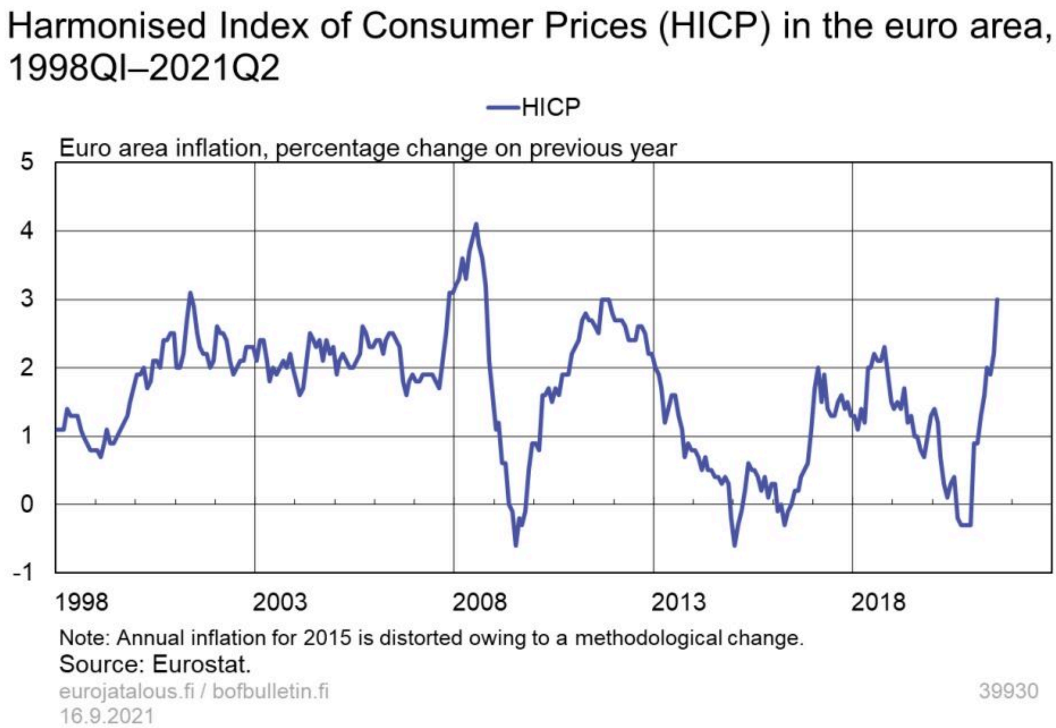
Successful monetary policy requires transparency and accountability. Monetary policy communication – i.e. the provision of information on monetary policy decisions to the media, general public, businesses and financial market participants – plays a key role in terms of the transmission of these decisions to the economy. This is why monetary policy communication was included in the strategy review. The role and importance of direct information channels and social media have increased at the expense of the traditional press and news channels. This requires a new type of communication policy from central banks that takes into account the target audience and the media.

The ECB's inflation target raised to 2%

The most important revision to the strategy concerns the definition of price stability and the ECB's inflation target. The new strategy introduces a symmetric inflation target of 2% over the medium term (Chart 2). The Governing Council also confirmed that the Harmonised Index of Consumer Prices (HICP)remains the appropriate price measure[7] and recommends that the costs related to owner-occupied housing be included in the HICP at a later stage (Chart 3).[8]

Chart 2.

Chart 3.



In its 2003 strategy review, the ECB decided to keep the definition of price stability unchanged, as an increase in prices at a rate below 2%. However, the definition was supplemented by an inflation target of ‘below, but close to, two per cent’, with the aim of creating a safety margin against deflation. The ECB’s double-key formulation of the price stability objective has since proved problematic; in principle, it allowed inflation to temporarily decline even close to zero. On the other hand, it was perceived as setting a 2% ceiling for inflation.

The previous strategy could well be justified at the time of the establishment of the monetary union, when the primary monetary policy concern related to inflation being too high and the ECB had to demonstrate its credibility in safeguarding price stability. The 2% inflation ceiling functioned well in a situation where inflationary pressures were predominantly elevated and the zero lower bound did not constrain monetary policy. Under those circumstances it was successful in anchoring inflation expectations at levels consistent with the inflation target.

The situation has changed since the global financial crisis, however, as inflationary pressures have been subdued and inflation has persisted at levels below the target. The 2% inflation ceiling may have contributed to lowering inflation expectations and inflation itself in an environment of contractionary monetary policy (Rostagno et al. 2019).

The new 2% inflation target is unambiguous, clear and easy to communicate. An inflation target of 2% underlines the ECB’s commitment to providing an adequate safety margin against the risk of deflation and ensuring sufficient room for monetary policy to counter too low inflation rates. The new inflation target is expected to influence long-term inflation expectations and to anchor them more solidly to the ECB's inflation aim.

The 2% target is estimated to limit excessive fluctuations in inflation and ultimately reduce the prevalence of periods when inflation is low and monetary policy is constrained by the zero lower bound on interest rates. Compared with the conditions during the 2003 strategy review, the risk of monetary policy rates hitting a level at which further substantial rate cuts are no longer possible, has increased, as has the risk of such episodes becoming longer (see e.g. Haavio and Laine (2021)). As stated above, this is primarily due to the fall in the equilibrium real interest rate.

The 2% inflation buffer allows for a smoother adjustment of macroeconomic imbalances across euro area countries. It also mitigates the rise in unemployment stemming from downward nominal wage rigidities and the risk of deflation during economic downturns. Furthermore, such a buffer takes into account the possibility of positive measurement bias in inflation, implying that the ‘true’ rate of inflation may be lower than the measured level.

Symmetry in the inflation target means that the Governing Council views both negative and positive deviations of inflation from the target as equally undesirable. This is a significant change to the ECB’s monetary policy strategy. Paloviita et al. (2021a, b) suggest that, prior to the strategy review, the ECB's de facto inflation aim was considerably below 2% (1.6%–1.8%) and that its objective with respect to inflation was asymmetric: the ECB was more averse to inflation above 2% than below 2%. Hence, this change in the strategy means that the ECB's actual inflation target is slightly higher than in the past.

Lower bound episodes necessitate especially forceful measures

Temporary fluctuations of inflation above and below the target are unavoidable. However, large and sustained deviations may be reflected in inflation expectations, and it is therefore important for monetary policy to respond equally forcefully to deviations of inflation from the target in either direction. The effective lower bound on interest rates and the low equilibrium real interest rate mean that persistent negative deviations are especially detrimental. The Governing Council's commitment to the symmetric 2% inflation target explicitly omits the below-2% bias related to the previous definition and, in particular, any remaining perception of 2% constituting a ceiling for inflation.

The Governing Council emphasises that the commitment to the symmetric inflation target requires especially forceful or persistent monetary policy measures based on a thorough impact assessment when the economy is operating close to the effective lower bound. This commitment is warranted by the need to support the anchoring of longer-term inflation expectations at 2%. In addition, close to the effective lower bound, the ECB stands ready to pursue accommodative monetary policy for a longer period for the stabilisation of economic developments and inflation. This may also imply a transitory period in which inflation is moderately above target.

The new strategy continues the medium-term orientation of the ECB's monetary policy. It is an important element of monetary policy that has served the Governing Council well in responding flexibly to different economic shocks. Flexibility is also needed as there is always uncertainty associated with the monetary policy transmission process, inflation developments and the determinants of inflation. In calibrating the appropriate stance of monetary policy, the identification of demand and supply shocks is of major importance. The ongoing COVID-19 crisis serves as a good example in this respect. As the crisis has eased, inflation has picked up, but it remains highly uncertain to what extent this is explained by supply problems and to what extent by the strong rebound in demand. If the main contributory factor to the faster pace of inflation is supply constraints on production, monetary policy should overlook the temporary upswing in inflation and allow inflation to rise even well above the target.

Asset purchases, longer-term refinancing operations and forward guidance remain in the monetary policy toolkit

Due to the decline in the equilibrium real interest rate and the zero lower bound constraint on monetary policy, central banks have resorted to, for example, extensive asset purchases and longer-term refinancing operations to halt the slowing of inflation. In the euro area, the need for these measures has been reinforced not only by global trends but also by the increasing divergence in the euro area economy as a result of the European debt crisis, the weakening of monetary policy transmission in the euro area and slower productivity growth.

After the financial crisis, the ECB gradually introduced new monetary policy instruments to complement its conventional interest rate policy. They proved to be effective in an environment of low inflationary pressures and have become permanent instruments in the ECB's monetary policy toolkit.

In addition, the space of the ECB's primary monetary policy instrument, i.e. the set of policy rates, has been extended into negative territory. The ECB's policy rate was at its highest level (4.75%) in the period between October 2000 and May 2001, and at its lowest (-0.5%) since September 2019 (Chart 4). The policy rate was set at zero already in July 2012. Only thereafter, in January 2015, did the ECB launch its expanded asset purchase programme. Negative policy rates have lowered short-term market rates, and the asset purchase programmes have resulted in a decline in long-term rates. For example, the yield on 10-year German government bonds declined in 2015–2019 from some 1.5% to some -0.25%. After 2019, the yield declined and was on average close to -0.5% (Chart 5).

The impact of interest rate policy and the purchase programme on market interest rates and related expectations has been enhanced by decisions on the duration and volume of the purchases.[9] Bank lending and lending rates have been influenced via targeted longer-term refinancing operations. In recent years, interest rate expectations have remained low typically 2–3 years ahead (Chart 6).

Chart 4.

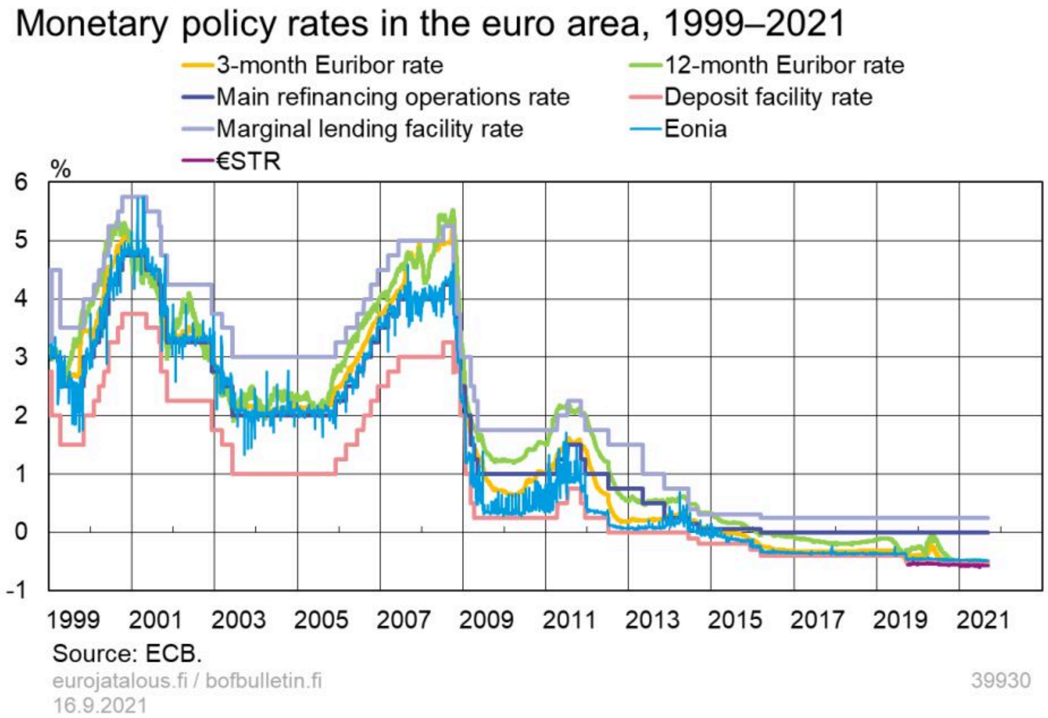

Monetary policy rates in the euro area, 1999–2021
3-month Euribor rate
12-month Euribor rate
Main refinancing operations rate
Deposit facility rate
Marginal lending facility rate
Eonia
€STR
%
6
5
4
3
2
1
0
-1
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019
2021
Source: ECB.
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Chart 5.

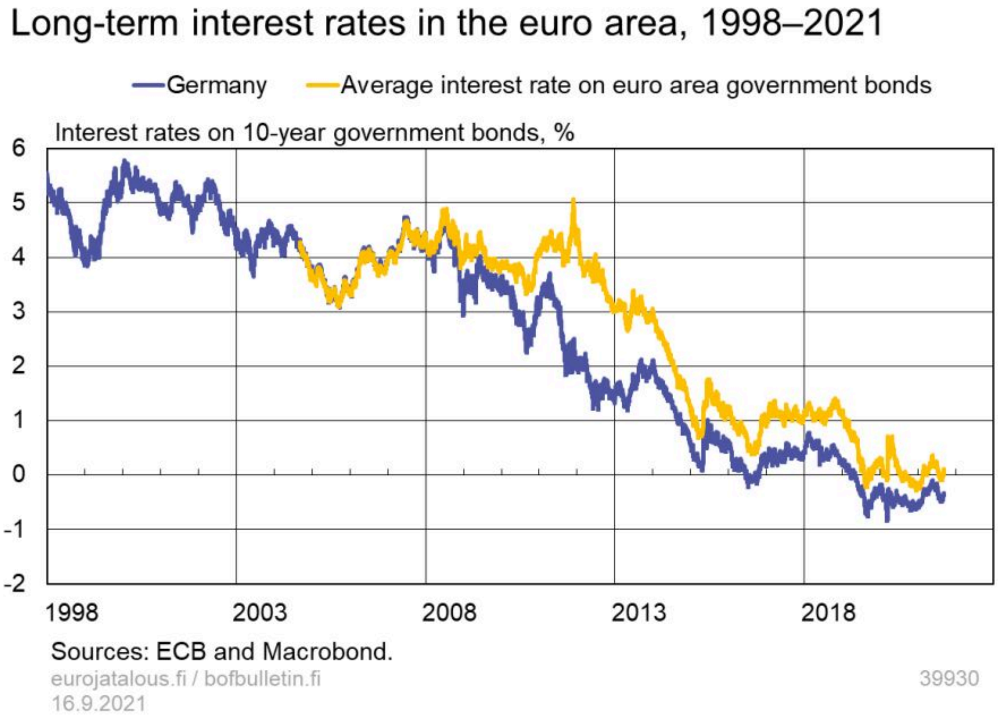
Long-term interest rates in the euro area, 1998–2021
Germany
Average interest rate on euro area government bonds
Interest rates on 10-year government bonds, %
6
5
4
3
2
1
0
-1
-2
1998
2003
2008
2013
2018
Sources: ECB and Macrobond.
eurojatalous.fi / bofbulletin.fi
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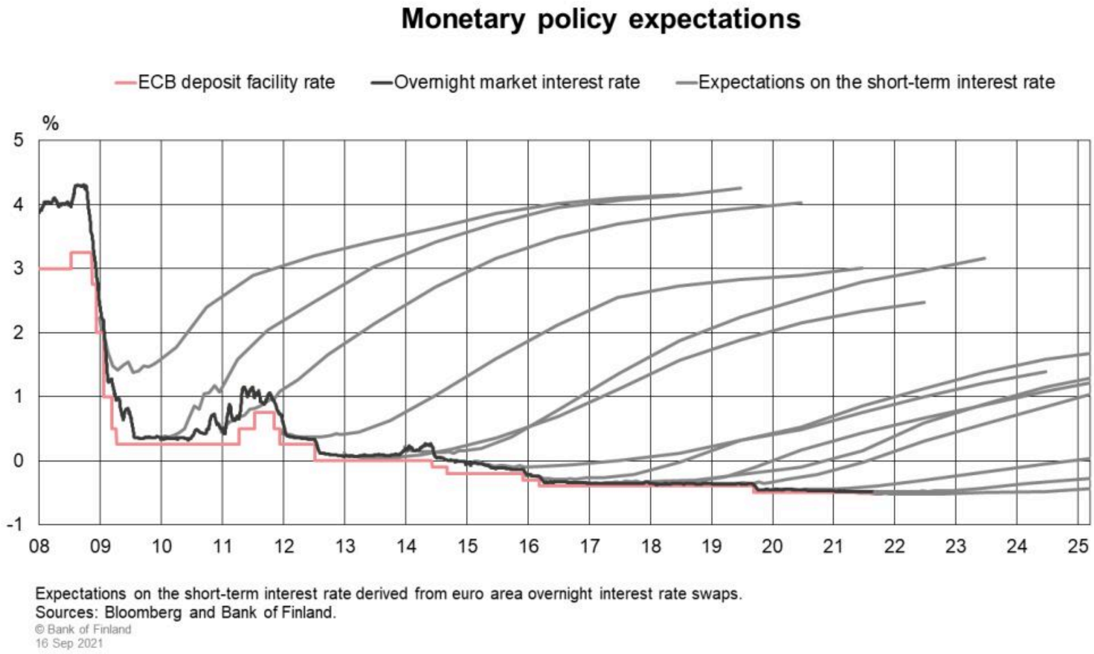
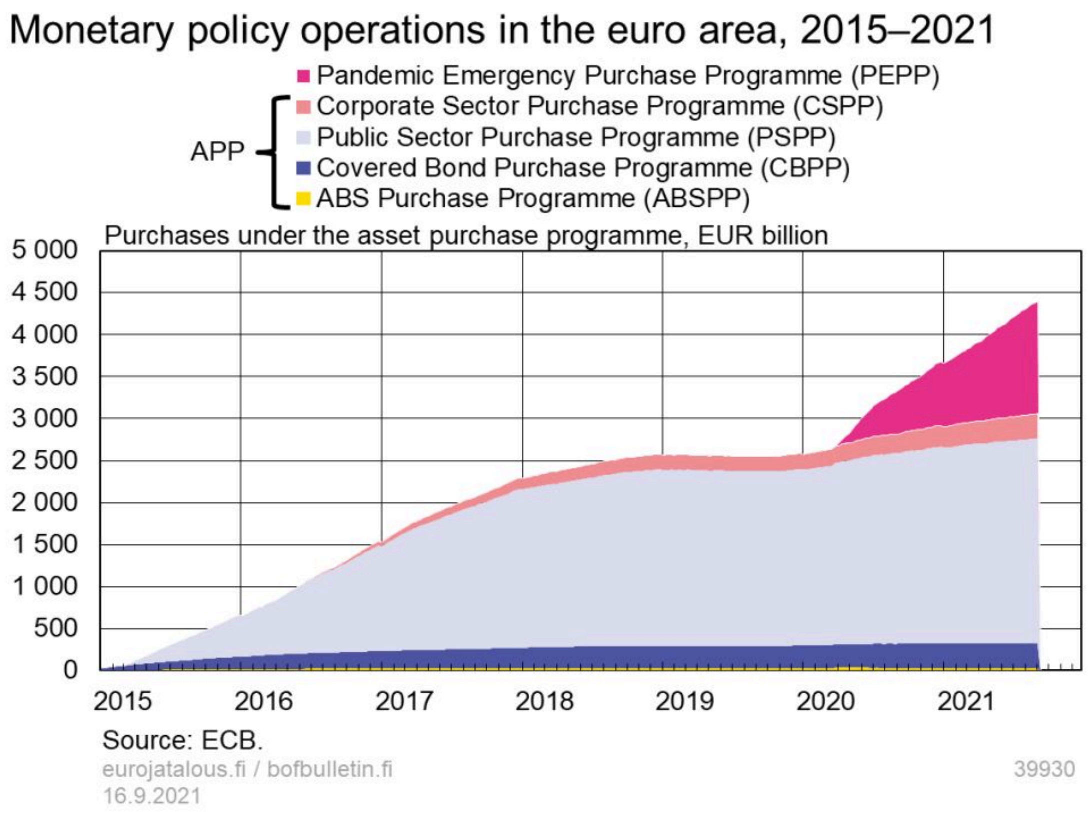
Chart 6.



The ECB has extended and amplified its monetary policy significantly in the pursuit of its medium-term inflation target. For example Rostagno et al. (2019), Nelimarkka and Laine (2021) and Laine (2021) estimate that the new monetary policy instruments have had a significant positive impact on bank lending, economic growth and inflation in the euro area.

On the other hand, these new policy instruments may have side effects and constraints from the perspective of financial stability, for example. Therefore, the Governing Council stresses in its revised strategy that it remains committed to continuing to perform careful proportionality assessments and to adapting the design of measures related to these instruments with a view to minimising side effects without prejudice to price stability.

Chart 7.



Macroeconomic stability-oriented fiscal policy taken into consideration in monetary policy

In proximity to the effective lower bound, the role of other economic policies than monetary policy becomes more important. Countercyclical fiscal policy may during deep recessions amplify the effectiveness of monetary policy.[10] During such times, monetary policy and discretionary fiscal policy may complement and amplify each other, which promotes economic recovery.

The experience gained in the financial crisis, the euro area sovereign debt crisis and the global pandemic suggests that effective macroeconomic stabilisation requires fiscal policy and monetary policy to complement each other in times of crisis. Moreover, there is ample empirical evidence suggesting that an expansionary fiscal policy is particularly effective when interest rates are near the lower bound. Fiscal and structural policies can also support productivity and labour supply growth, helping to reverse the trend in the equilibrium real interest rate and thereby create monetary policy space.

The ECB continues to support the EU’s economic policy

Without prejudice to price stability, in its monetary policy decisions the Governing Council of the ECB caters to other considerations relevant to the conduct of monetary policy.

The Treaty on European Union states that the primary objective of the European System of Central Banks (ESCB) is to maintain price stability. The ESCB supports the general economic policies in the European Union with a view to contributing to the achievement of the Union’s objectives as laid down in Article 3 of the Treaty on European Union, without prejudice to the objective of price stability. These objectives include sustainable development that is based on balanced economic growth and price stability, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

The ESCB contributes to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system. In addition, the ESCB acts in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

For example, when adjusting its monetary policy instruments, the Governing Council will choose the configuration that best supports the general economic policies of the Union related to growth, employment and social inclusion, and that protects financial stability and helps to mitigate the impact of climate change.

Price stability, balanced economic growth and full employment are mutually consistent objectives

Price stability, balanced economic growth and full employment are to a large extent mutually consistent economic policy objectives. As defined in its strategy, the ECB is pursuing price stability in the medium term. This enables a flexible monetary policy response to various economic shocks, as described below.

Flexibility means that the Governing Council may decide to lengthen the horizon over which inflation returns to the target level. For example, in the presence of an adverse supply shock, the Governing Council may decide not to tighten its monetary policy in order to avoid pronounced falls in economic activity and employment. The shock, if persistent, could jeopardise price stability. The challenge of monetary policy is thus that the assessment of long-term risks to price stability requires information on the level of potential output and equilibrium employment relative to current activity and employment.

Due to these challenges, the ECB did not commit in its new strategy to any particular estimate of potential output or equilibrium employment. The Governing Council decisions seek to account for the uncertainty and heterogeneity related to these unobservable variables. It also considers the ongoing structural changes shaping the outlook for economic activity and employment in the euro area and its member countries. The Governing Council continues to assess the interaction between monetary policy and the distribution of income and wealth.

Financial stability is a precondition for price stability, and vice versa

Under stressed financial market conditions, monetary policy measures aimed at maintaining price stability typically seek to safeguard financial market liquidity but also to support the monetary policy transmission mechanism and to avert the weakening of bank balance sheets and lending capacity[11] as well as debt deflation.[12]

In the maintaining of financial stability, the primary responsibility lies with macroprudential and microprudential policy decision-makers. Price stability is also improved by the prevention of financial imbalances and excessive risk-taking and the enhancement of supervisory and macroprudential policies related to balance sheets and risk buffers.

Monetary policy loosening during recessions and tightening during upswings supports financial stability. On the other hand, an accommodative monetary policy stance for too long may increase the build-up of leverage and fuel a rise in asset prices, whereas a too tight or incorrectly calibrated monetary policy stance may push the economy into recession.

While it is reasonable for the ECB to take financial stability considerations into account in its monetary policy deliberations, it is important to note that monetary policy does not have the primary responsibility for guaranteeing financial stability. Monetary policy is not systematically tightened when systemic risk builds up or systematically loosened when systemic risk materialises.

Financial stability considerations are taken into account flexibly in monetary policy, and any monetary policy response will depend on prevailing circumstances, without prejudice to medium-term price stability. To this end, the preparation of monetary policy deliberations will be enhanced with additional information on financial stability considerations, in the context of overhauling the ECB’s analytical framework.

The ECB contributes to the mitigation of climate change

The Governing Council of the ECB also decided on an action plan to include climate change considerations in its monetary policy framework. With this decision, the Governing Council underlines its commitment to more systematically reflect environmental sustainability considerations in its monetary policy.

Climate change is a global challenge and a policy priority for the European Union. While governments and parliaments have the primary responsibility for climate policy, the ECB, within its mandate, seeks to promote climate change objectives. The ECB is expanding its analytical capacity in macroeconomic modelling with regard to climate change and promotes the disclosure and assessment of risks related to climate change so that they can be taken into account in risk management, investment activities and monetary policy operations.

The ECB revised its integrated analytical framework for monetary policy

The structural changes in the economy that have had consequences for the growth potential of the euro area economy, the equilibrium real interest rate, the inflation process and the transmission of monetary policy are continuously reflected in the analytical tools and framework of the euro area monetary policy preparation process. These factors were also among the reasons underlying the strategy review. The ECB has considered these changes gradually and analysed their effects from the perspective of monetary policy. The previous monetary policy strategy, which was based on two pillars – economic analysis and monetary analysis – has become more comprehensive and robust.

Changes to the economic analysis, which focuses on real economic developments and price developments, reflect the diversification of statistical and economic indicators as well as modelling and computational developments. Changes to the economic analysis reflect the increasing importance of the Eurosystem and ECB staff macroeconomic projections in forming a view on the medium-term outlook for economic activity and inflation, and the more systematic analysis of (changes to) structural trends.

The monetary analysis has shifted from its main role of detecting risks to price stability over medium to longer-term horizons based on monetary aggregates, towards an extensive analysis for assessing monetary policy transmission. This shift in focus reflects a weakening of the empirical link between monetary aggregates and inflation, growing impairments in monetary policy transmission during the global financial crisis and the broadening of the ECB's monetary policy toolkit.

Given these changes, the ECB's monetary policy deliberations will be based on a revised integrated analytical framework that brings together two analyses: the economic analysis (that focuses on the real economy and price developments) and the monetary and financial analysis. The new framework will replace the previous two-pillar framework and discontinue the cross-checking of the information derived from the monetary analysis with the information from the economic analysis. The analytical tools and models will be subject to continuous development.

Monetary policy communication more understandable

The importance of monetary policy communication has increased significantly over time. The better monetary policy is understood, not only by experts but also by the general public, the more effective it will be.

Monetary policy communication also plays a key role in ensuring that the ECB as an independent central bank fulfils its duty of accountability towards the public and retains credibility and legitimacy. Consistent, transparent and clear communication to as wide an audience as possible is essential.

The Governing Council is committed to explaining its monetary policy strategy and decisions as clearly as possible to all audiences. Communication of monetary policy decisions will continue to build on four products that have proven their value: the press release, the introductory statement, which will be renamed the 'monetary policy statement', the Economic Bulletin and the monetary policy accounts. These products will be complemented by a layered and more visual version of policy communication geared towards the wider public.

During the strategy review period, the ECB and national central banks listened to citizens' views on inflation, employment and sustainable economic growth. The dialogue and interaction with the public will be continued on a regular basis, to enable the Eurosystem to communicate in an understandable manner on its decisions, which have an impact on nearly all the aspects of economic activity.

The Governing Council of the ECB also estimates that, in a rapidly changing world, its monetary policy strategy is likely to need a regular review. It is already foreseeable that the digital central bank currency, expected changes in the architecture of EMU, rapid developments on the financial markets, the increasing role of financial intermediation by non-banks, and other structural changes in the economy will alter the landscape in which monetary policy operates. The Governing Council intends to assess the appropriateness of its monetary policy strategy again in 2025.

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Footnotes

1. The ECB published a wide range of articles related to the strategy review on September 21, 2021. ↑
2. The level of interest rate consistent with inflation at its target and where economic resources are in full use, see e.g. Laubach and Williams (2003), Holston et al. (2016) and Vilmi (2017). Estimates of the level of the equilibrium interest rate vary and are subject to uncertainty. ↑
3. See e.g. Juselius and Takáts (2018) and Goodhart and Pradhan (2020). ↑
4. A level of interest rates below which further rate cuts would lead to more negative than positive effects (see e.g. Altavilla et al. 2021). ↑
5. See Rostagno et al. (2019) and Hartmann and Smets (2018). ↑
6. Climate change and the transition towards a more sustainable economy affect the outlook for price stability through their impact on macroeconomic indicators such as inflation, total output, employment, interest rates, investment and productivity, financial stability, and the transmission of monetary policy. Moreover, climate change and the carbon transition will affect the value and the risk profile of the assets held on the Eurosystem's balance sheet, potentially leading to an undesirable accumulation of climate-related financial risks. The Governing Council has decided on an ambitious climate change action plan. ↑
7. The consumer price index (CPI) is a measure of changes over time in prices of goods and services purchased by consumers. In addition to their national CPI, the EU Member States each produce an HICP. The EU's statistical authority Eurostat calculates common indices for the EU and EMU countries (European Index of Consumer Prices and Monetary Union Index of Consumer Prices) based on the HICPs calculated by the Member States. The calculation of the HICP is guided by EU regulations, which enables comparisons of inflation between the EU Member States. ↑
8. This will be possible when the Eurosystem has harmonised and comprehensive data on the costs of owner-occupied housing are available for all euro area countries. ↑
9. The Governing Council's commitment to continue its accommodative monetary policy stance also in future is in economic literature referred to as 'forward guidance of monetary policy'. ↑

10. The use of countercyclical fiscal policy during recessions requires correspondingly that buffers are built up during upswings to safeguard fiscal sustainability. ↑
11. In economic literature, this phenomenon is referred to as ‘negative macro-financial feedback effects’. ↑
12. In debt deflation, a fall in prices increases the real value of the debt. ↑

Key words

climate change, employment, inflation, inflation targeting, monetary policy, monetary policy strategy