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New era, new strategy: the ECB's revised approach to monetary policy

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On 8 July 2021, the European Central Bank revealed its revised monetary policy strategy. It had been a long time coming: the previous strategy had been in place for eighteen years and even then had not changed much from the original strategy agreed in October 1998, just prior to the launch of monetary union. A review to be concluded by the end of 2020 had been announced in January 2020, but was extended in April 2020, because of the pandemic, until the second semester of 2021.

Apart from the time elapsed since the last review, a key rationale for having it is that profound economic change has reduced the scope for the ECB 'and other central banks to achieve their objectives by exclusively relying on changes in policy interest rates'. These changes are diverse: an ageing population, the legacy of the global financial crisis, digitalisation and new forms of globalisation. The statement also draws attention to the threats from climate change.

Background

The ECB's 'two-pillar' approach to monetary policy was strongly influenced by Otmar Issing, the German member of its Executive Board, formerly of the Bundesbank. The first pillar was to monitor the growth of the money supply – a long-standing element of German monetary policy prior to the launch of the euro. The second pillar is more relevant to the short-term and consists of leading indicators and measures of inflation expectations. In the words of Issing, Gaspar, Angeloni and Tristani, in a book published in 2001: 'the range of relevant indicators, and their relative importance, change over time. Consequently there is no permanently valid way to organise the assessment in a logically consistent manner'.

In 2003, the first and second pillars were reversed, suggesting that the monetary pillar was being down-graded in importance. However, Issing et al. had previously explained that the separation between first and second pillar should 'be seen mainly as an organisational framework to structure the available information, both internally and for the benefit of the public'.

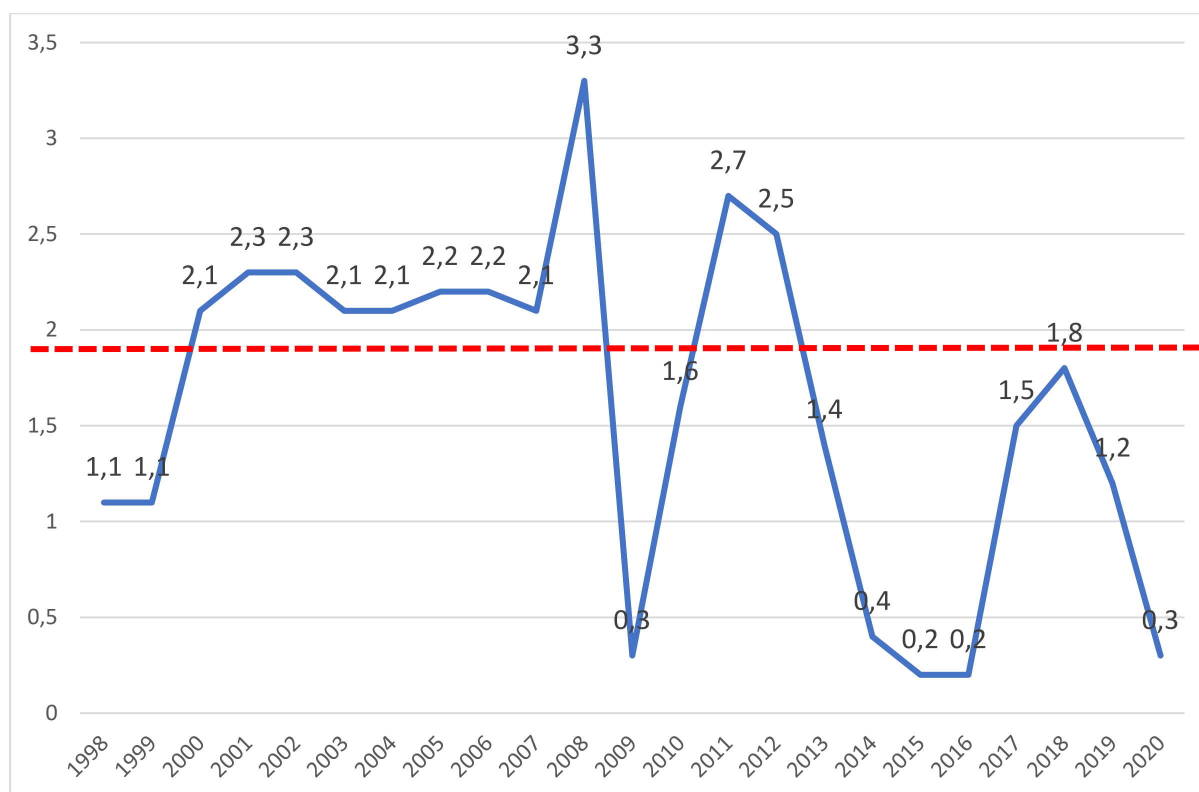
The ECB strategy in its original form differed markedly from those of other leading central banks. It was considered asymmetric in setting an upper bound, but not a lower bound, implying inflation could be anywhere between zero and just below 2%. This contrasted with the mandate given to the Bank of England of an inflation target of 2%, with the Governor obliged to write a letter of explanation to the government if the rate deviated from the target by more than one percentage point. The US Fed, too, had a symmetric inflation target, also 2%, but its most striking difference compared with the ECB is its dual mandate, requiring it to pay heed to both the level of employment and price stability.

What's new?

The headline innovation is to adopt a symmetrical inflation target of 2%, measured by the harmonised index of consumer prices (HICP). According to the summary, 'symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable'. In a statement seized on by many commentators, when the interest rate is close to the effective lower bound, the ECB will resort to 'especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target'. Paragraph 8 of the statement reaffirms use of the interest rate as the primary policy tool, but goes on to list other instruments it might employ: 'in particular forward guidance, asset purchases and longer-term refinancing operations, as appropriate' and leaves open the option of 'new policy instruments'.

In light of the inflation record of the last decade, forceful policy action to boost core inflation might be considered overdue. Since the sovereign debt crisis started to abate in 2012, the inflation rate in the euro area, as measured by the harmonised index of consumer prices, has been consistently below the reference value. Figure 1 shows these annual values relative to an assumed target (the red dashed line) of 1.9%. Indeed, in the seven years from 2013 to 2019, now seen as a period of recovery from the worst of the crisis, the inflation rate averaged just 1%. This may not be a dramatic under-shoot, but it puts in perspective some of the worries about the continued use of non-conventional policies, especially the Eurosystem's programmes of asset purchases.

Figure 1 Annualised increase in the euro area harmonised index of consumer prices, %



Source: ECB

A second notable change is to include the housing costs of owner occupiers in the version of the HICP used to measure inflation. Because such a change will take time to implement, the ECB promises only to 'take into account inflation measures that include initial estimates of the cost of owner-occupied housing in its wider set of supplementary inflation indicators'. But to the extent that housing costs have tended to rise faster than those of other goods and services, it could become a tighter inflation target.

A third – if surprisingly vague – innovation concerns climate change. The cautiously worded statement is:

> 'within its mandate, the Governing Council is committed to ensuring that the Eurosystem fully takes into account, in line with the EU's climate goals and objectives, the implications of climate change and the carbon transition for monetary policy and central banking'.
>
> In a further statement showing signs of every word having been fought over, we learn that 'the Governing Council will adapt the design of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework'.

While it makes sense to incorporate climate risks into monetary policy decisions, the statement leaves uncertain how proactive the ECB plans to be in promoting action to mitigate climate change risks, as opposed to price stability and financial stability. This is a theme which has exercised many central banks and given rise to a number of suggestions, such as giving preference to 'green' bonds. According to David Marsh and Danae Kyriakopoulou 'the approach is focused on risk, with language about risks posed on finance by climate change, not the effect finance has on climate (the so-called double-materiality)'. As such, it will disappoint climate activists.

What other central banks do

The ECB is not alone in reviewing its approach. In August 2020, the Fed announced the outcome of its own review of its long-term monetary policy framework, its first ever, launched in 2019. Although both price stability and employment objectives were close to being achieved when the review began, a prime motivation for the review was the 'changes in the economic environment' especially the lower 'neutral' level of the interest rate needed to keep 'the economy on an even keel when employment and inflation are close to their objectives'. The Fed notes that this rate has fallen in the US and elsewhere, increasing the likelihood 'that the policy rate will fall to its effective lower bound near zero', and thus detract from the scope for monetary policy to stabilise the economy.

An admirably succinct overview provides clarity on both the new strategy and its predecessor by showing the precise changes of wording in – in effect – tracked changes. A first, possibly only symbolic, change is to reverse the order of the passages on employment and inflation, to put the former first. Noting the uncertainty about what the maximum level of employment is (the expression 'full employment' is not used), making a formal employment target inappropriate, the new approach nevertheless now explicitly refers to 'shortfalls of employment from its maximum level'. An inflation target of 2% is retained, but a significant innovation concerns the anchoring of inflation expectations. Previously, the Fed had a symmetric target, implying it would react 'if inflation were running persistently above or below this objective'. This has been replaced.

The new approach will, instead, seek 'to achieve inflation that averages 2 percent over time'. This means that 'following periods when inflation has been running persistently below 2 percent,

appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time'. This is not quite price level targeting, but it implies that the level as well as the change in the level of prices will be taken into account. After a period of subdued inflation in recent years, it also implies inflation higher than 2% for some time until economic actors – households and corporates, as well as financial markets –again become used to thinking of 2% as what to expect.

The Bank of England, in contrast to the ECB and the Fed, has its numerical inflation target set annually by the government, rather than a qualitative target of price stability. Although the Bank has operational independence in how it conducts policy, it cannot unilaterally alter the definition of price stability. If inflation exceeds or falls short of the target by one percentage point, the Governor of the Bank of England is obliged to write to the Chancellor of the Exchequer (the UK term for Finance Minister) to explain the deviation and the action proposed to correct it. Although the extensive quantitative easing programmes undertaken since 2009 came under close scrutiny from the government and parliamentary committees, they are formally at the discretion of the Bank in its operation of monetary policy.

One key area where the Bank of England has gone further than the ECB is in relation to climate change. In the 2021 annual update of the government's remit, among the wider economic policy objectives the Monetary Policy Committee is asked to take into account is 'supporting the transition to a net zero economy'. In 2020, the Bank had initiated an annual report on its approach to managing the risks from climate change (the second was published on 17th June 2021) and by the end of 2021 will start implementing a strategy to 'green' its holdings of corporate bonds. In its role as prudential supervisor, the Bank has also pushed financial intermediaries to assess climate risks and to take steps to enhance their resilience against these risks.

Assessment of new approach

Unsurprisingly, the new ECB approach evokes many and mixed reactions. A rapid appraisal by two experienced commentators, Ignazio Angeloni and Daniel Gros, observes that 'anything that happens after 18 years of waiting stands a good chance of being celebrated', but they seem disinclined to open the champagne, adding that the 'review disappoints expectations on several fronts'. Reporting on the decision for *Politico*, Johanna Treeck wrote 'the ECB took a conservative approach on the hotly debated question of whether to reference allowing inflation to overshoot the target after years of undershooting, merely acknowledging the possibility that this could happen'. Intriguingly, though, she reports that the Governors of the Finnish (Olli Rehn) and Italian (Ignazio Visco) central banks – one seen by many observers as a 'creditor' country, the other as a persistent 'debtor' – had pushed for the more radical approach adopted by the Fed.

On the whole, market commentators, if not quite dismissive, consider the new approach to be underwhelming. For example, Konstantin Veit of Pimco believes 'the new strategy means, by and large, old policy, and cements the revealed preference of maintaining the current monetary policy configuration for longer instead of easing conditions aggressively'. Martin Lück of Blackrock said 'Der Berg kreißte und gebar eine Maus' [direct translation: the mountain laboured and brought forth a mouse; an equivalent English expression would be to make a mountain out of a molehill], adding 'rissen niemanden vom Stuhl' [no-one fell of his chair]. He also notes the stark contrast with the more far-reaching changes adopted by the Fed.

Implicitly, these critics disagree with the statement at the press conference on 8th July from Christine Lagarde, ECB President, in response to a challenge that the new approach would not really

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change how monetary policy is conducted. She replied: 'On your other question, "this strategy is really not much". I am very sorry, but I don't believe so. I think it is quite a lot'. A possible reconciliation of these view is that to obtain, successfully, the unanimous support of the Governing Council, there needed to be some vagueness in the language.

There are, inevitably in matters European, questions around 'who prevailed?' and whether the new strategy shifts policy in directions some might find uncomfortable. David Marsh and Danae Kyriakopoulou suggest German preferences – which they see as aligned with other 'hawks', who they identify as Austria, Belgium, the Netherlands and the Baltic States – have largely been satisfied. But others, including some prominent German commentators, demur. The key area of contestation is how the ECB goes about achieving the new goals of raising inflation rate from the low levels of recent years.

In particular, is an inflation rate above 2% to be tolerated for long enough to shift expectations? It would imply keeping interest rates low for longer and, as Christian Siedenbiedel points out in a column published on 10th July in the *Frankfurter Allgemeine Zeitung*, will be damaging for the many savers in Germany already upset by persistently low returns on their savings. By contrast, writing in *El Pais* on 8th July 2021, Claudio Pérez claimed that if the inflation hawks had prevailed in response to German fears, 'eso sería letal para una economía como la Española' [it would have been lethal for an economy like Spain's] characterised by high debt. The price will be higher inflation, but that has the benefit of eroding the real value of the debt.

Operational as opposed to strategic issues

Any strategy provides a broad roadmap for what is supposed to be achieved and how to achieve it, and the new ECB approach to monetary policy decisions is no exception. Any strategy is also an attempt to reconcile conflicting views and preferences. In this regard, the challenge for the ECB can be more daunting than for other central banks, because it has not only to satisfy distinct constituencies (citizens, markets, other policymakers), but deeply entrenched differences among the members of the euro area.

From this perspective, the manifest ambiguity in some elements of the revised strategy can serve a useful political purpose by enabling competing interests to identify room for their preferences to be accommodated when monetary policy decisions are taken. However, it is a fine line, because 'good' monetary policy also has to convey a sense of stability and certainty. Consequently, how the new strategy is implemented will be crucial.

As the ECB has been at pains to point out, the new strategy was agreed unanimously by the Governing Council, but had it not been it would have raised awkward questions about its legitimacy. Even so, reports of dissent surfaced and it is noteworthy that during the first press conference two weeks after the new strategy was adopted, Christine Lagarde conceded during the Q&A, in response to a question about forward guidance, that 'we did not have unanimity, but we had an overwhelming majority about the calibration of the forward guidance on ECB interest rates'. She took comfort from the fact that there had been full agreement on the need to 'revise the forward guidance as we did, but also to make sure that it is geared to implement our strategy'.

Clashes on key decisions are nothing new and many would argue that some of the actions of the ECB over the last decade were hard to defend in terms of the strategy defined in 2003. But others will argue that resort to what are sometimes called unconventional policies were pragmatic and

necessary, and need to be remain in place for some time. The new strategy plainly allows for this to happen and the smoke signals from Frankfurt suggest little inclination to rein in asset purchases any time soon.

Trouble can, nevertheless be expected when decisions consistent with a strategy deemed to have too much flexibility of interpretation are at odds with the expectations of some stakeholders, especially in northern member states. But trouble can also be expected if inflation hawks on the Governing Council push for a quicker return to more conventional monetary policy, implying an early end to bond purchases, before the risk to financial and macroeconomic stability have abated in southern Europe. The language in both the new strategy and at the July 22nd press conference suggests that southern Europe can relax – at least for now.

Concluding comments

The ECB's monetary policy strategy has undoubtedly evolved markedly from the relatively straightforward approach to policy decision-making adopted when the euro was launched, with its strong emphasis on price stability. The table below offers a synoptic summary of the evolution to what is a more complex one. As noted by Martin Sandbu, writing in the *Financial Times*, the new approach 'gets rid of many things that made the ECB stand out like a sore thumb among central banks — in particular those features that fuelled perceptions the Frankfurt-based institution had a deflationary bias'. It is part of a journey which has seen the ECB acquire new responsibilities in recent years for prudential supervision and resolution of failing banks, participation in 'Troika' missions and the acquisition of a *de facto* lender of last resort role.

Table: the evolving monetary policy strategy of the ECB

	1999	2003	2009-20	2021
Inflation target	Under 2% HICP; asymmetric	Close to but below 2% HICP; asymmetric		2% HICP; symmetric target, but without an explicit range; owner-occupied housing HICP to be added
Approach	Two pillar strategy: first monetary; second range of other indicators	Two pillar strategy: first, range of indicators; second monetary	Same two pillar strategy, with more attention to financial stability	Two pillar strategy: first, range of indicators; second monetary and financial analysis
Objective	Mainly price stability		Price stability and financial stability	Price stability, financial stability and some allowance for fiscal stability
Unconventional policies	No; interest rate as primary instrument		Progressively greater use of QE some forward guidance	Willingness to use range of tried and, if needed, untried instruments
Climate change	Not seen as part of monetary policy strategy			Becomes part of risk assessments, but still tentative

Source: own elaboration

But the new monetary policy strategy also bears the hallmarks of the compromises needed for it to be unanimously agreed by the Governing Council. Language open to differing interpretations was probably unavoidable, but carries the risk of engendering uncertainty on what will be done, when and with what consequences. Stating that 'the Governing Council has committed to an ambitious climate-related action plan' is valuable, but leaves open too many questions about what it will mean in practice.

The next review will be held in five years' time, giving the ECB the opportunity to look afresh at some of the trickier aspects of the monetary policy strategy. In the meantime, it would be no surprise if cases were brought before the German Constitutional Court (and maybe others) to challenge the new approach, and if political leaders sought to influence the implementation of the strategy. In navigating these currents, the ECB will have to be particularly sensitive to the concerns of southern countries about premature 'normalisation'. The disappointment expressed in some quarters about the limited radicalism of what has been agreed may be justified, but needs to be tempered by recognising just how difficult it is to turn this particular ocean liner.