EVOLUTION, NOT REVOLUTION. THE ECB'S CHANGE OF COURSE.
The past 18th of July, after 18 months of deliberations, the European Central Bank made public its new strategy review. With this new strategy the European monetary institution moves away from its last strategy, published in 2003, changing the way in which it acts to deliver its main objective of price stability. With this article we aim to mention the main elements of the strategy as well as providing some details related to the rationale and thinking behind it.

The main variations that have been introduced with the strategy review have to do with the price stability goal, the attitude of the central bank towards climate change and the way in which the ECB analyses and communicates the economic developments and decisions.

The first change that the review has introduced is related with the inflation objective. In the past, the ECB has been characterized for being one of the only major central banks whose inflation target was not 2%. In contrast, ECB’s monetary strategy was based on a double-key formulation of the price stability objective aimed to maintain the Harmonised Index of Consumer Prices (HICP) in a level that was “below but close to 2%” over the medium term. With the strategy review the ECB is now targeting in a symmetric way a rate of inflation of 2% over the medium term using the HICP.

Regarding the HICP, given the demands of the general public, the ECB will include the costs of the owner-occupied housing (OOH), comprising the “consumption” component of housing. The inclusion of the OOH in the HICP will be done with the help of Eurostat and it will take some years due to the lack of comparable data among the different Eurozone countries. During the transitional period, if data is available, the ECB will use the new stream of data as a complement to its analysis. Concerning the changes in the rate of inflation, the inclusion of the OOH in the HICP will not have a strong effect on the rate of inflation, according to UniCredit Research the inclusion will be able to lift headline inflation by 0.1-0.2pp.

Furthermore, the new formulation of the price stability goal will be symmetrical around 2% with positive and negative deviations being equally undesirable. In addition to this and, in contrast of what was happening with the “below but close to 2%” goal, the current target will not be interpreted as a ceiling since the rate of inflation tolerated by the central bank can now be above the 2%. As a justification of this possible overshooting, the ECB acknowledges that large and sustained deviations from the objective can destabilize long-term inflation expectations, making more difficult the task of the central bank. This situation is very likely taking into account the current environment characterized by the low levels of equilibrium interest rates and the constraints imposed by the Zero Lower Bound.¹

In order to achieve inflation rates above the 2%, the ECB proposes the use of monetary policy, in a “forceful and persistent” way through “non-conventional” measures such as forward guidance, negative rates, liquidity provisions, quantitative easing and dual rates.
The opinion that existed around the initial inflation goal of the ECB, “below but close to 2%”, was that the target was contributing to lower the rate of inflation and the inflation expectations due to its ambiguity and asymmetry. In this regard, the change to a 2% inflation target is well welcomed, as it will be perceived as a simple, clear and easy to communicate goal that will help to better anchor the long-term inflation expectations, exerting a positive influence over the rate of inflation.

It is important to mention that the ECB’s “overshooting” strategy is completely different to the Flexible Average Inflation Targeting (FAIT) adopted by the Federal Reserve in 2020. If it is true that both strategies allow for an overshoot, the monetary policy stance of the Fed is likely to remain more dovish than the one of the ECB. This is mainly due to the fact that the triggers of the overshooting are different between the two central banks. In the case of the Fed, the FAIT, since it is aiming for an average inflation rate of 2%, allows for inflation overshooting if the inflation rate has been under 2% during the previous years. When it comes to the ECB, the inflation overshooting is allowed just in the cases in which the ZLB is binding or in periods characterized by negative price shocks. Concerning tolerance of the inflation overshoot, for reasons that have to do with flexibility, any central bank has mentioned the deviations that they are willing to tolerate. Despite this, the marked differences within the ECB’S Governing Council will make more difficult for the European institution to keep the inflation rate above 2% for long periods of time.

The second major shift for the ECB comes with the assumption of new roles as an institution eager to fight climate change. The central bank assumes these new roles for two different reasons. The first one has to do with the formulation of the EU Treaties according to which the Eurosystem has to support the economic policies in the EU, being one of them the transition to a low-carbon economy. The second one is related with the fact that the physical and transitional risks associated with climate change have implications for price and financial stability and affect the value of the assets currently held on the Eurosystem balance sheet. Despite the more active paper of the ECB fighting climate change, the institution claims that the main efforts in regards to the climate question should come from Governments.

In relation with the specific ways in which the ECB is going to act, they are mainly related with the inclusion of the impact of climate change and the carbon transition into their analysis and the disclosure of information, in the short term. Apart from this and, following a predefined roadmap, Frankfurt has announced the conduct of climate stress testing and the adjustment of the requirements of eligibility for asset purchases and collateral, favouring low carbon industries. These changes are expected to be fully included in the operational framework by 2022.
In third place, the ECB has also reformulated its analytical two-pillar framework. Since 2003, the monetary policy stance of the ECB has been based on the economic and monetary analysis performed by the institution. While the economic analysis was targeted to the study of real and nominal variables, the monetary analysis has been more directed towards the study of the channels of monetary policy transmission, partially abandoning the study of the evolution of monetary aggregates. With the strategy review and, learning from the experiences of the Great Recession and the Eurozone crisis, the ECB has decided to dismantle the two-pillar strategy incorporating the study of financial conditions and the feedbacks that exist between the three typologies of analysis. Prior to the strategy review, the ECB was de facto conducting this type of analysis.

Finally, some changes in regard to communication have been also included in the review. The ECB is now searching for an easier way to communicate its results with the goal of making its operative and decision-making process more accessible to citizens. Apart from this, the monetary institution has announced that its next strategy review will take place in the year 2025.

**SOME CRITIZISM.**

In a general way, the results of the strategy review have been welcomed by the market participants. Although, there have been some claims arguing that the ECB has missed an opportunity to adapt its operative to the new economic reality.

One of the most common claims is related with the fact that the ECB has not explained why they have been underachieving their inflation target during the majority of the last two decades. As shown by the core inflation metrics, the average inflation has been around 1.5% since 2003. This track of underperformance has made some analyst to believe that the current conventional and unconventional tools available for the ECB will not be enough to reach the 2% inflation goal, harming the credibility of the monetary institution. In this light, some authors have proposed to increase the categories of private assets that can be purchased by the ECB or even to intervene directly in the market of inflation derivatives.

Criticism has also been raised around the lack of mention of the self-imposed limits for the purchasing of assets and the ruling of the European Court of Justice. In this regard, in a near future, some of the programmes included under the roof of the Quantitative Easing could be easily challenged from a legal point of view.
Finally, some analysts also argue that the ECB, has not mentioned enough the increasing role of fiscal policy when determining the rate of inflation. According to these analysts, the weaker links among employment, wages and prices have effectively decreased the degree in which monetary policy can exert an influence on the rate of inflation. In this situation and, given the less clear macro effects of the QE, the effects of monetary policy are highly contingent on the use of fiscal policy.

CONCLUSION.

Overall, the strategy review can be understood as a step in the right way, an evolution more than a revolution. It is positive mainly due to the fact that the ECB has acknowledged, although imperfectly, some of its limitations. Furthermore, it prevents the preemptive tightening of the monetary policy stance, as the one that took place in 2011. According to some market participants, the ECB could have adapted more to the current economic environment adopting a more “dovish” framework, but this was not compatible with the unanimity of the Governing Council, an important objective according to Christine Lagarde. In the short run it is likely that the set of measures being conducted by Frankfurt will not change. Beyond this short term, the complications for the ECB will come once their intentions will have to be backed by the “forceful and persistent” reactions necessary to achieve a 2% inflation rate.

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1- The main problem associated with the Zero Lower Bound is that it constrains the degree in which a central bank can react to negative shocks. As it is happening since 2008, the state of the economy needs the use of negative nominal rates in order to achieve full employment. Although, the effects associated with the central bank going negative can harm the stability of the banking system and the financial markets, outweighing the positive effects of the decrease in nominal rates. The inability to reduce nominal rates below the 0% forces central banks to make use of unconventional measures.

2- The disclosure of information is related with the provision of statistics related with the carbon footprint of financial institutions, the exposure to climate risks and the covering of relevant green financial instruments.

3- With the self-imposed limits, the ECB is not able to acquire more than the 33% of the public debt, of each member estate, in circulation. Furthermore, in the medium term, the acquisitions of public debt should be aligned with the capital keys, the contributions of each central banks to the ECB's capital.

4- According to the verdict of the supranational Court, the QE programme is compatible with the EU Treaties as long it is limited and temporary.
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