ECB monetary policy: Strategic review

SUMMARY

In July 2021, the European Central Bank (ECB), the central bank of the 19 European Union countries that have adopted the euro, completed its first monetary policy strategic review for 18 years. The key change, after 18 months of consultation, was a new interpretation of price stability (the ECB’s primary objective) as a symmetric inflation rate of 2% over the medium term.

The aim of this year’s review was to adapt monetary policy and central banking to broader macroeconomic trends, such as digitalisation, globalisation and demographic change, while also giving consideration to the implications of climate change and the carbon transition, in line with the EU’s climate goals and objectives. The result will have substantial implications for the primary objective (price stability), for the ECB’s monetary policy assessment and for its monetary policy operational framework.

In short, the revised monetary policy strategy brings the ECB’s overall strategic orientation closer to its central bank peers, shifting away from curbing high inflation towards ensuring it does not dip too low, while also building climate considerations into the policy framework.
Introduction

The long-awaited second review of the ECB’s monetary strategy, the first in 18 years, was preceded by an extensive 18-month consultation process. In its last review, in 2003, the ECB changed its interpretation of price stability (the primary objective, see Section 2.1), to an inflation rate of ‘below, but close to, 2% over the medium term’. While this updated policy objective proved able to keep the underlying inflation trend relatively stable during the global financial crisis of 2007 to 2009, a set of non-standard policy measures were introduced in order to avoid the risk of rapid deleveraging by banks and other credit institutions. The subsequent EU economic and sovereign debt crises laid bare the deficient institutional design of the Union’s monetary and fiscal policy, as the centralised monetary policy, led by the ECB, is counter posed with a decentralised fiscal apparatus. While the sovereign-debt spreads had eased significantly by the end of 2012, something that prompted the ECB to start tightening its monetary stance, inflation rates meanwhile fell throughout the Eurozone and highlighted yet another macro-economic challenge, the risk of deflation.

Since then, the Harmonised Index of Consumer Prices (HICP), the price measure for assessing the achievement of the price stability objective, has remained mostly below target, with several deflationary spells, in particular for individual euro Member States in the geographic south. The challenge of protracted deflationary periods has been aggravated by the central bank approaching the lower bound of policy rates (that is, the interest rate on the main refinancing operations, on the deposit facility and the marginal lending facility). This ‘zero lower bound’ (ZLB) severely limits the capacity of the ECB to ensure price stability with ‘conventional’ monetary policy tools. Therefore, the ECB (like other major central banks around the world) has introduced a wide range of novel monetary policy tools in recent years, such as negative interest rates, forward guidance, long-term refinancing operations and asset purchases. To re-calibrate the new toolset with a forward-looking strategy, the ECB published a review of its monetary strategy in July 2021.

1. The ECB's monetary strategy and its objectives

The ECB is responsible for monetary policy of those EU member countries that have adopted the euro as their currency. Since its inception on 1 June 1998, the ECB’s legal framework has been defined in the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU) and in particular Protocol (No 4). While the ECB is the monetary authority of the euro area, it is important to acknowledge that its mandate, set out in Article 127(1) TFEU, applies to the central banks of all Member States of the Union, including countries outside the economic and monetary union, the ‘European System of Central Banks’.

The TFEU is clear about the ECB’s primary objective — price stability: ‘The primary objective of the European System of Central Banks (hereinafter referred to as “the ESCB”) shall be to maintain price stability.’ However, the exact (quantitative) definition of price stability is defined by the ECB itself and therefore not specified in the Treaties. The ECB’s monetary strategy provides clarity in this regard and consequently gives the central bank scope to establish (and revise, if necessary) its definition of price stability. For instance, the last strategy, in place for the last 18 years (2003-2021) defined price stability as ‘a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 %’ (see below, point 2.2). The clear focus on price stability offers clarity and accountability towards the public while also anchoring the inflation target in the medium term. The medium-term orientation of monetary policy arises from the volatile and uncertain process between the formulation of monetary policy and actual change in prices. It affords the ECB’s decision-making body, the Governing Council, the flexibility it needs to tailor policy responses to the size, persistence and type of shock it is facing. For instance, supply side shocks (reductions in an economy’s capacity to produce goods and services) often require a lengthening of the medium-term horizon to mitigate negative effects on real economic activity and employment.
Despite unprecedented monetary policy accommodation, inflation in the euro area has averaged just 1.2 % since the global financial crisis, well below the target adopted by the Governing Council in the monetary strategy in 2003. This period of protracted disinflation in combination with various other structural changes, such as like demographic trends in euro countries and a general decline in the natural interest rate, prompted the need to revise the monetary strategy for the euro area.

While price stability is the ECB’s paramount policy objective, the mandate includes a wider policy narrative: ‘Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union’. This secondary objective offers a much wider interpretation of the ECB’s mandate, as long as it is consistent with price stability. There are many connecting factors between monetary policy and the general economic policies of the EU, which adds considerable complexity to the ECB’s policy choices. Indeed, monetary policy decisions need to weigh up trade-offs between different EU goals. The basis for the ECB’s monetary policy decisions, including the evaluation of the proportionality of its decisions and potential side effects, is a ‘two-pillar’ approach, with economic analysis on one side and monetary and financial analysis on the other. The former focuses mainly on an assessment of real and nominal economic developments in the light of short-to-medium term risks to price stability. The monetary and financial analysis examines relevant indicators, with a particular focus on the monetary transmission mechanism and possible risks to medium-to-long term price stability.

2. What has changed?

Launched on 23 January 2020, the ECB published its new monetary strategy review after an 18-month process, organised in 13 separate work streams and involving numerous listening activities with the general public, civil society organisations and academics. Those efforts reflect an acknowledgement that the world has changed in fundamental ways since 2003, when the last strategy was formulated. According to the ECB, the two main developments prompting the new strategy are, first, the gradual and persistent decline in the ‘real equilibrium’ interest rate, the rate that balances savings and investments, and, second, a period of protracted disinflation in the eurozone, with an average inflation rate of 1.2 % since the global financial crisis. While both developments pose severe challenges for monetary policy, the limited policy space to respond to disinflationary spells at the zero lower bound was given special consideration in the new monetary policy strategy, since price stability is the policy’s primary objective.

2.1 Primary objective

The most significant innovation set out in the new strategy is a re-phrasing of the primary objective. The policy statement reads that the ‘Governing Council considers that price stability is best maintained by aiming for two per cent inflation over the medium term’. This might seem semantically negligible but it has considerable implications: compared with the inflation goal formulated in 2003 (an inflation rate below, but close to, 2 %) this constitutes a clear shift towards a symmetric 2 % target (see Figure 1). ‘Symmetric’ meaning that the ECB considers ‘negative and positive deviations from this target as equally undesirable’. In re-directing its inflation target, the ECB is acknowledging the limitations of its monetary policy when the economy is close to the zero lower bound and is prepared, if necessary, to implement ‘forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched’. While the new strategy does not specify any range around the inflation target, it states that a transitory period in which inflation is moderately above target can be accepted. This contrasts with the former target, which had an implicit bias towards inflation rates below 2 %, hinting that the ECB cared more about inflation being too high than about inflation being too low and potentially implying that 2 % was a ceiling rather than a target.
2.2 Harmonised Indicator for Consumer Prices (HICP)

The underlying indicator for assessing the achievement of the price stability objective is the Harmonised Indicator for Consumer Prices, which measures price developments of the consumption basket representing people’s actual consumption behaviour. One component only partly taken into account so far in the HICP that has exhibited large and persistent price changes in recent past years is the cost of housing. While residential property prices in the euro area have increased, on average, at an annual rate above 4% in the last four years, owner-occupied housing was not included in the representative consumption basket. The monetary policy strategy sets out a road map to address this issue and include owner-occupied housing in the index. This means, that the augmented HICP will treat home purchases in much the same way as purchases of other durable goods, e.g. cars, based on the net acquisition approach. Inclusion in the HICP of the consumption aspect of owning a home will represent actual consumption expenditures by households more accurately. Given that the monetary policy strategy refers to a multi-year project to include owner-occupied housing in its inflation measurement and that Eurostat will carry out the measurement, it is unclear when exactly the amended HICP will be the basis of Governing Council decision-making. In the meantime, inflation measures that include initial estimates of the cost of owner-occupied housing will be taken into account by the ECB in its wider set of supplementary inflation indicators.

2.3 Implications of climate change

Although the ECB’s scope to address climate risk within the remit of its mandate is still subject to debate, a growing number of commentators argue that central banks should consider the implications of climate change. The rationale of why the implications of climate change should be taken into account and how the ECB can consider its role in addressing the challenges arising from climate change are described in the updated monetary policy strategy. The positioning of the ECB was carved out already prior to the release of the strategy. For instance, in a speech made at the ECB DG-Research Symposium, Isabell Schnabel, Member of the ECB’s Executive Board, argued that the primary mandate requires the ECB to account for potential risks posed by climate change to price stability. Similarly, ECB president Christine Lagarde declared in a speech in mid-July 2021 that, ‘as the pandemic passes, we need to shift the focus from preserving the economy to transforming it’. Accordingly, the ECB published a separate statement, announcing an action plan with a roadmap to include climate change considerations in its policy framework and a commitment ‘to implementing the action plan in line with progress on the EU policies and initiatives in the field of environmental sustainability disclosure and reporting’. This will also include adapting the design of the monetary policy operational framework, since climate change and the transition towards a more sustainable
economy are expected to affect the outlook for price stability through their impact on macroeconomic indicators such as inflation, output, employment, interest rates, investment and productivity, financial stability, and the transmission of monetary policy. More specifically, the roadmap outlines a plan comprising detailed climate change-related measures to be implemented in the next four years.31 For instance, the development of new macroeconomic models to monitor the implications of climate change for monetary policy, the introduction of new indicators covering green financial instruments and the carbon footprint of financial institutions, or new climate stress tests for banks in the Eurosystem. While the ECB is guided by the principle of market neutrality,32 it is not per se a rule in primary law.33 Thus, the commitment to reflect environmental sustainability considerations more systematically in its monetary policy has now been outlined in the new monetary policy strategy within the existing mandate.34 The strategy statement specifically reads that ‘the ECB, within its mandate, recognises the need to further incorporate climate considerations into its policy framework’.

2.4 Analytical framework

In addition to refining the analytical toolset with regard to the impact of climate change on price stability and its implications for banking supervision, the ECB also revised its analytical framework. In doing so, it recognised that future policy measures might necessitate a ‘more forceful or persistent policy response’ in cases of protracted inflation close to the lower bound. This stronger monetary policy response may in turn come with risks to medium-term price stability from financial imbalances and monetary factors. Therefore, the monetary and financial analysis pillar has been revised to focus on the monetary transmission mechanism,35 in particular via the bank lending, risk-taking and asset pricing channels, to monitor and evaluate the longer-term build-up of financial vulnerabilities and imbalances. This is not to imply that monetary policy will be systematically tightened when systemic risk builds up.36 The goal of the revised monetary and financial analysis is to facilitate a more systematic evaluation of potential financial vulnerabilities in the future.

Comparison with other central bank peers

Established on 1 January 1999, the ECB is among the youngest central banks and looks back at a much shorter history compared with peers such as the Federal Reserve System of the United States (established in 1914) or the Bank of Japan (1882).37 The historical backdrop has and is still influencing the structure of these three central banks and consequently their monetary policy conduct. Nevertheless, there are significant common features, such as the concept of independence and autonomous decision-making, transparency to retain legitimacy and accountability, and the adoption of monetary policy committees. This has narrowed the differences, not only in the conduct of their respective monetary policy decisions, but also in the overall mandate of these three central banks.

Mandate

The (legal) framework within which central banks conduct their monetary policies and from which they draw their legitimacy is set out in their mandates. As described above, the overarching goal of the ECB is price stability, now defined as a symmetric goal of an inflation rate of 2%. Similarly, the Bank of Japan (BoJ) focuses on a clear primary objective of price stability, which, according to the BoJ Act states that the Bank’s monetary policy should be ‘aimed at achieving price stability, thereby contributing to the sound development of the national economy’.38 Both the ECB and the BoJ with a lexicographic ordering of objectives, placing price stability above other objectives, contrast with the Federal Reserve’s (Fed) multiple-objective mandate. Under that mandate, the Fed is under an obligation to ‘maintain long-run growth of the monetary and credit aggregates commensurate with the country’s long-run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates’.39 The goals of maximum employment and stable prices are often referred to as the Fed’s ‘dual mandate’.
Definition of price stability

For the Fed, the BoJ and the ECB alike, the basis of the price stability mandate is an inflation measure. While the ECB just re-calibrated its target to a symmetric 2% inflation rate, taking into account a long-term spell of low inflation rates close to the ZLB, the Fed finished a similar exercise in mid-2020. The updated ‘Statement on Longer-Run Goals and Monetary Policy Strategy’, published as part of a review process, first in 2012 and at five-yearly intervals since, shifts away from a symmetric inflation target (of the kind just implemented by the ECB) towards ‘a flexible form of average inflation targeting’. Average inflation targeting implies that when inflation undershoots the target for a time, the Fed will direct monetary policy to push inflation above the target for some time to compensate. However, ambiguity remains about over what period of time the Fed will seek to have inflation average 2% or how much over 2% it intends to push inflation. A similar perception of ambiguity arose after the ECB published its new strategy as to what deviation the ECB is willing to tolerate around the 2% target. With a longer history of monetary policy at the zero lower bound, the BoJ released a ‘New Framework for Strengthening Monetary Easing’ in September 2016, consisting of a policy framework for ‘yield curve control’ and an ‘inflation overshooting commitment, in which the Bank commits to continuing to expand the monetary base until the year-on-year rate of increase in the observed CPI exceeds 2 percent and stays above the target in a stable manner’.

Green monetary policy

The first central bank to build climate risk and policy systematically into monetary policy was the Bank of England through a recent mandate change bringing its operations in line with the UK government’s net-zero carbon strategy. Since then, the ECB has followed major central banks in a shift away from market neutrality towards a low-carbon economy, for instance through clear criteria based on climate risk considerations when buying corporate bonds and accepting collaterals from financial institutions. While the ECB has not changed its mandate, it did announce a climate action plan and detailed timeline for the next four years as part of its updated monetary policy strategy. However, the ECB has not committed to any changes to its main refinancing operations, unlike the Bank of Japan, which recently announced that it would use targeted refinancing operations to support the transition to a carbon neutral economy. Following a meeting of the Bank’s monetary policy committee in June, the BoJ published a statement on its strategy on climate change in which it announces a new lending facility to offer funds to banks at a preferential rate when they lend to projects in new growth areas.

Climate change and risks are currently being reviewed and discussed at the Fed, yet little detail has been provided on how it intends to address these issues. Earlier this year, the Fed set up two committees to assess the effects of climate change on financial institutions (micro prudential) and the financial system (macro prudential). This puts the Fed behind compared with other central bank peers when it comes to incorporating climate risks in its monetary policy framework.

3. Conclusion

The second review of the ECB’s monetary policy strategy constitutes a shift in three major areas: (1) the inflation target, a long-standing source of ambiguity, has been re-calibrated to a symmetric inflation target of 2%; (2) the underlying inflation measure, the Harmonised Index of Consumer Prices (HICP), will be amended to include the costs related to owner-occupied housing; and (3) a climate-related action plan has been announced that will build climate factors into the ECB’s monetary policy assessments and adaptation of its monetary policy operational framework.

This review of the ECB’s monetary policy strategy brings the overall strategic orientation of the ECB closer to those of its major central bank peers. First and foremost, the new strategy reflects a shift from curbing high inflation towards ensuring it does not dip too low. However, it remains to be seen at what degree of inflationary overshooting the monetary stance will be reversed towards
tightening. This is a particularly pressing question since inflation rates are rising owing to strong economic recovery from the pandemic. Second, the new strategy announces a multi-year project to incorporate owner-occupied housing into the HICP, but the exact form this will take and the timeline have still to be clarified. Finally, the extent to which and how the ECB will pursue its ‘secondary objectives’ has not been addressed by the second review of the monetary strategy, as the implications of climate change are subsumed under the primary objective. Against the backdrop of a decade of strong disinflationary forces, the monetary policy review has been conducted in unprecedented times, during a pandemic that has seen monetary policy reacting fast to cushion the effects of the most severe economic recession since the 1930s. As an atypical recovery gets under way, the new monetary policy strategy is now to be put to the test.

MAIN REFERENCES

ECB, Monetary policy strategy statement, July 2021.
Lagarde C., Financing a green and digital recovery, speech at the Brussels Economic Forum, June 2021.
Schnabel I., From market neutrality to market efficiency, speech at the ECB DG-Research Symposium ‘Climate change, financial markets and green growth’, June 2021.

ENDNOTES

1 See ECB’s monetary policy strategy, 2021.
2 See ECB’s monetary policy strategy, 2003.
3 For instance, extension of the maturity of liquidity provisions, extension of eligible collateral accepted for re-financing operations and additional liquidity provisions in foreign currencies. For more information, see A. Delivorias, Monetary policy of the ECB, EPRS, European Parliament, 2015.
4 The zero lower bound occurs when the short-term nominal interest rate is at or near to zero, which limits the central bank’s capacity to stimulate economic growth. For more, see M. Ulate, ‘Going Negative at the Zero Lower Bound: The Effects of Negative Nominal Interest Rates’, American Economic Review, Vol. 111(1), January 2021.
5 The main refinancing operations (MRO) rate is the interest rate banks pay when they borrow money from the ECB for one week.
6 The deposit facility rate defines the interest banks receive for depositing money with the central bank overnight.
7 The marginal lending facility rate is the interest rate banks pay when they borrow from the ECB overnight.
8 More details on the ECB’s negative interest rates.
9 See forward guidance as defined by the ECB.
10 Further explanation on targeted long-term refinancing operations (TLTROs).
11 More information on the expanded asset purchase programme.
13 See Protocol (No 4) on the Statute of the European System of Central Banks and of the ECB.
14 See ECB’s detailed explanation on the transmission mechanism of monetary policy.
15 The Governing Council is the main decision-making body of the ECB.
16 A slow-down in price increases, as opposed to deflation, which is a decrease in general price levels.
17 The equilibrium rate that supports the economy at full employment/maximum output while keeping inflation constant.
18 See the Consolidated version of the Treaty on European Union.
19 See for instance Setting New Priorities for the ECB’s Mandate, which investigates the links between price stability and secondary objectives and includes a general discussion on the viability of the ECB mandate.
20 Proportionality regulates how the EU exercises its powers. The proportionality principle means that, to achieve its aims, the EU (and in this case the ECB) will only take the action it needs to and no more.
21 For more information, see ECB explanations of economic analysis – assessing the short- to medium-term determinants of price developments – and monetary analysis – focusing on the longer-term horizon of price stability.
22 The natural or neutral rate of interest corresponds to a situation in which the economy is operating at potential and inflation is at its target value, such that there is no reason for the central bank to either inject or withdraw stimulus. This natural rate (in academia labelled as $r^*$) is declining also in real terms, that is inflation adjusted, as described in a [speech](https://www.ecb.europa.eu/eca/eng/publications/speeches/html/ecb_20151118_en.html) by P. R. Lane, Member of the Executive Board of the ECB.


24 The net acquisitions approach is a method for measuring owner occupiers’ housing costs that are associated with the purchase and ongoing ownership of dwellings for own use.

25 The net acquisitions approach treats a home as the purchase of a good that is part asset (the land) and part consumable (the house) and usually excludes the land component from the price index component.


28 The speech, entitled 'From market neutrality to market efficiency' substantiates this point.


30 See [ECB presents action plan to include climate change considerations in its monetary policy strategy](https://www.ecb.europa.eu/pub/pdf/other/ecb_actions_feb21_en.pdf).

31 See [action plan to include climate change considerations in its monetary policy strategy](https://www.ecb.europa.eu/eca/eng/publications/speeches/html/ecb_20210902_en.html).

32 B. Cœuré, former Member of the Executive Board of the ECB, first mentioned the market neutrality principle in 2015. See also B. Cœuré, 2015, 'Embarking on public sector asset purchases'. The concept of market neutrality means that the price discovery mechanism is not suppressed by monetary policy measures. For instance, corporate bond purchases reflect the composition of the overall market.


35 A description of the process through which monetary policy decisions affect the economy in general and the price level in particular can be found [here](https://www.ecb.europa.eu/eca/eng/publications/speeches/html/ecb_20151118_en.html).

36 See the transcript of a speech by I. Schnabel, Member of the Executive Board of the ECB, at the virtual Financial Statements series hosted by the Peterson Institute for International Economics ‘[A new strategy for a changing world](https://www.ecb.europa.eu/eca/eng/publications/speeches/html/ecb_20201118_en.html)’.

37 The Eurosystem became operational slightly before in 1998. Of course many national central banks of the Eurosystem were established much earlier, e.g. the Banque de France in 1800, De Nederlandsche Bank in 1814, the Banque Nationale de Belgique in 1850, the Banco de España in 1856, the Banca d’Italia in 1893 and the Deutsche Bundesbank in 1957.


39 See the Fed's [monetary policy objectives](https://www.federalreserve.gov/monetarypolicy/policygoals.htm).


41 See the BoJ's [Quantitative and Qualitative Monetary Easing with Yield Curve Control](https://www.boj.or.jp/en/monetary_policy/qqe/).

42 The [announcement](https://www.boj.or.jp/en/monetary_policy/qqe/20200130statement.htm) will allow the Bank of England to add climate and sustainability criteria to its corporate bond purchases and other monetary policy operations.

43 See [The Bank of Japan’s Strategy on Climate Change](https://www.boj.or.jp/en/monetary_policy/qqe/20200130statement.htm). Furthermore, in a speech in July, the Governor of the Bank of Japan somewhat attenuated the market neutrality stance of the BoJ, stating ‘market neutrality needs to be interpreted with some latitude’.


**DISCLAIMER AND COPYRIGHT**

This document is prepared for, and addressed to, the Members and staff of the European Parliament as background material to assist them in their parliamentary work. The content of the document is the sole responsibility of its author(s) and any opinions expressed herein should not be taken to represent an official position of the Parliament.

Reproduction and translation for non-commercial purposes are authorised, provided the source is acknowledged and the European Parliament is given prior notice and sent a copy.


Photo credits: © Stockfotos-MG / Adobe Stock

eprs@ep.europa.eu (contact)

www.eprs.ep.parl.union.eu (intranet)

www.europarl.europa.eu/thinktank (internet)

http://epthinktank.eu (blog)