The ECB's strategy review: How monetary policy can be better communicated to the public

At the beginning of this year, the European Central Bank (ECB) launched a new strategy review, with two of the key pillars of this review focusing on its communication strategy and how monetary policy can address climate change. **Markus Demary** *and* **Michael Hüther** *argue the ECB should prioritise communicating with social groups unfamiliar with monetary policy and should take a responsive, but not activist, approach to climate change.*

In January, the President of the European Central Bank, Christine Lagarde, launched a comprehensive review of the ECB's monetary policy strategy. The last such review took place 17 years ago, in 2003. The current review includes a survey of different social groups, such as firms and households. In carrying out this survey, the ECB acknowledges that communication with a broader public beyond financial market specialists is important and that it has not properly addressed the public in the past. There is recognition that central banks, as 'unelected powers' without democratic legitimation, must face up to public debates in a special way, so that their actions can be comprehended.

Broadening communication

Communication and accountability are key pillars of the inflation targeting framework that was originally proposed by Lars E.O. Svensson. In this framework, communication with the public is a policy tool for managing inflation expectations, since expectations contribute to future inflation dynamics. This is reflected in the ECB's forward guidance, which aims to stabilise inflation expectations by communicating the future path of monetary policy interest rates.

However, ECB communications are often limited to communiques with the European Parliament, the European Commission and press conferences and speeches aimed at high-level audiences. It is therefore questionable whether this communication approach reaches the general public, including companies that set prices and wages. This starts with the ECB's overuse of technical language ('PSPP', 'LTRO', 'TLTRO', and others), much of which is barely understood outside of the finance and research community. Moreover, the inflation expectations of different social groups differ a lot from financial market experts' forecasts, on which the ECB relies.

Variations in the cost of living between social groups

The reason for this is that the cost of living for different social groups differs from the cost of living for a representative household, from which the consumer price index is calculated. Poorer households, for example, are more affected by price increases in relation to rent and food than richer households, because rent and food make up a larger part of their consumption basket. In addition, goods with decreasing prices, like telecommunication products, make up a smaller part of their consumption basket compared to richer households. Studies in the US find, for example, that poorer households are much more affected by increases in fuel prices and that older households are more affected by increases in healthcare expenditure.

Different consumption patterns contribute to variation in subjective inflation expectations. Thus, households with a higher share of price-sensitive goods and services in their consumption basket will have a hard time acknowledging that a two percent inflation target is in line with price stability, since they see their costs of living increase. Communicating the need for and the benefits of an accommodative monetary policy is especially important with respect to these households because a lack of comprehensiveness lowers the acceptance of monetary policy.

ECB President Christine Lagarde taking part in an 'ECB Listens' event in October 2020. Credit: Bernd Hartung/European Central Bank (CC BY-NC-ND 2.0)

The acceptance and understanding of central bank decisions could be improved by including the effects of central bank decisions on employment into central bank communications. This is because households can observe that accommodative monetary policies lower their interest rate incomes, while they cannot observe how accommodative monetary policies stabilise their labour income.

While labour market policy or health policy is well understood by the population, the same is not true of monetary policy. One cause is that the population's financial education has not kept pace with developments in the financial industry. Therefore, financial market topics have to be taught on a much broader scale. Former US Federal Reserve President Alan Greenspan has used the media very heavily. He was known to a large part of the population through TV appearances, although he was often not understood. It would be desirable if more and continuous exchanges were sought from the ECB's board members, especially in popular media formats.

Failure to meet the inflation target

The failure to meet inflation targets in many currency areas over the past decade reflects the fact that inflation targeting – despite its introduction reducing inflation rates in industrialised countries – cannot credibly increase inflation rates if the banking system and companies are persistently stuck in a balance sheet recession. The two percent upper limit seems credible, but not the two percent point target.

The US Federal Reserve switched to average inflation targeting after a prolonged period of low inflation rates, during which the price level increase was well and sustainably below the two percent inflation level. But the fact remains that managing inflation expectations does not work if only financial market experts are consulted when measuring them and a large part of the population does not understand the technical details of inflation targeting. As a consequence, the strategy change to average inflation targeting could be interpreted as a justification for a longer period of expansionary monetary policy by the broader public.

Monetary policy and sustainable finance

Appropriate public communication will be made all the more difficult if monetary policy is overhauled with additional objectives. As important as the EU's new Green Deal is, monetary policy can make little contribution to its implementation. While the ECB may support general economic policy, it must also be market-neutral. When buying securities, it is therefore already difficult to take climate neutrality into account. If x percent of the bond market consists of green bonds, the ECB can also buy x percent of its monetary policy securities in green bonds without violating market neutrality. This would no longer be the case if the ECB deviated from the x percent threshold in its monetary policy operations.

However, climate risks are becoming increasingly relevant for the financial sector. Rating agencies are taking climate risks into account in their ratings and, increasingly, rating downgrades due to weather risks are taking place instead. If climate risks cause the creditworthiness of companies to fall and thus credit risks to rise, the ECB must address this in its collateral framework.

In this way, the ECB is quite capable of accompanying the general trend towards sustainable finance; it must even do so in its role as supervisor (if, for example, credit risks from green projects are underestimated). Moreover, a change in investment behaviour can influence the transmission process, which would be relevant for the ECB. But it can do so from an observing and reacting position. It is not the task of a central bank to support or slow down a structural change. That is the task of development banks.

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