Box 4

REVIEW OF THE EUROPEAN CENTRAL BANK'S MONETARY POLICY STRATEGY

Ana Arencibia Pareja

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In accordance with Article 127 of the Treaty on the Functioning of the European Union (TFEU), the primary mandate of the Eurosystem, which is comprised of the European Central Bank (ECB) and the national central banks of the countries which have adopted the euro, is to maintain price stability in the euro area as a whole. However, the TFEU leaves to the discretion of the ECB the exact definition of "price stability" and the manner in which it is to be achieved. These two aspects are part of what is known as the monetary policy strategy.

This strategy, as that of the other central banks,[1] may be updated to adapt to a constantly changing economic and financial reality and, at the same time, to incorporate the lessons learned from its implementation over time. In this regard, the new structural challenges deriving from the fall in the equilibrium real interest rates,[2] digitalisation, globalisation and climate change, among other factors, led the Governing Council of the ECB[3] to conduct, from early 2020, a new review of its monetary policy strategy, following the last review in 2003.[4]

On 8 July 2021, the ECB presented the outcome of this review, establishing an updated strategy that will determine the orientation of its monetary policy over the next few years.[5] This box details some of the main changes introduced in this review.

First, the ECB's Governing Council sets a new 2% inflation target over the medium term.[6] This target is symmetric, meaning positive and negative deviations of inflation from the reference rate of 2% are equally undesirable. Therefore, in comparison with the previous definition of this target (an inflation rate below, but close to, 2%), the new formulation removes both any ambiguity about the numerical inflation target and the possible perception of asymmetry regarding the degree of tolerance to future positive or negative deviations of inflation from the target.

Second, in order to maintain the symmetry of its inflation target, the ECB recognises the importance of taking into account, when implementing its monetary policy, the implications of the effective lower bound on interest rates. This is understood as the level below which a central bank cannot reduce its interest rates without causing potentially significant distortions to the functioning of the financial system, which would prove harmful for the economy as a whole. This lower bound – to which the ECB has come close in recent years after setting its key interest rates at all-time lows (see Chart 1) – reduces the headroom for implementing an expansionary monetary policy. Also, the aforementioned fall in equilibrium interest rates implies that this lower bound might constrain monetary policy more frequently in the future.[7] Therefore, in recognition of the greater impact of this lower bound in the current context, the ECB's new strategy establishes that when the economy operates close to that limit, especially forceful or persistent monetary policy measures are required to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above the medium-term target of 2%.

Third, the ECB's new strategy confirms that the key ECB interest rates are the main instrument for the conduct of its monetary policy. However, it also establishes that it will continue to use forward guidance, asset purchases and longer-term refinancing operations, as appropriate, and leaves open the possibility of introducing new instruments

1 See, for instance, "Review of the Federal Reserve's monetary policy strategy: main aspects and impact on the financial markets", Box 2, "Quarterly report on the Spanish economy", *Economic Bulletin,* 3/2020, Banco de España.

2 The natural or equilibrium interest rates are those which prevail when the economy remains at its potential level and inflation stable at its target level. For a detailed analysis of the natural interest rate and its implications for monetary policy, see A. Galesi, G. Nuño and C. Thomas (2017), "The natural interest rate: concept, determinants and implications for monetary policy", Analytical Articles, *Economic Bulletin,* 1/2017, Banco de España.

3 The Governing Council is the main decision-making body of the ECB. Its main responsibilities include adopting monetary policy decisions with the aim of achieving price stability.

4 See ECB press release "The ECB's monetary policy strategy", of 8 May 2003.

5 See ECB press release "ECB's Governing Council approves its new monetary policy strategy", of 8 July 2021.

6 There are several reasons for setting an inflation target of 2%, rather than, for instance, 0%. First, a higher inflation target reduces the probability that the lower bound on interest rates will restrict the central bank's capacity to conduct an expansionary monetary policy. In addition, a 2% rate is low enough to fully reap the benefits of price stability and, at the same time, it provides a margin to reduce the risks of deflation. Lastly, a 2% inflation rate leaves room for possible differences between the inflation rates of the different euro area countries, preventing some countries from having to maintain excessively low or even negative inflation rates while other countries experience higher inflation rates.

7 For a detailed analysis of monetary policy in an environment of interest rates close to their effective lower bounds, see Banco de España (2018), "Monetary policy design in the medium and long-term", Chapter 3, *Annual Report 2018.*

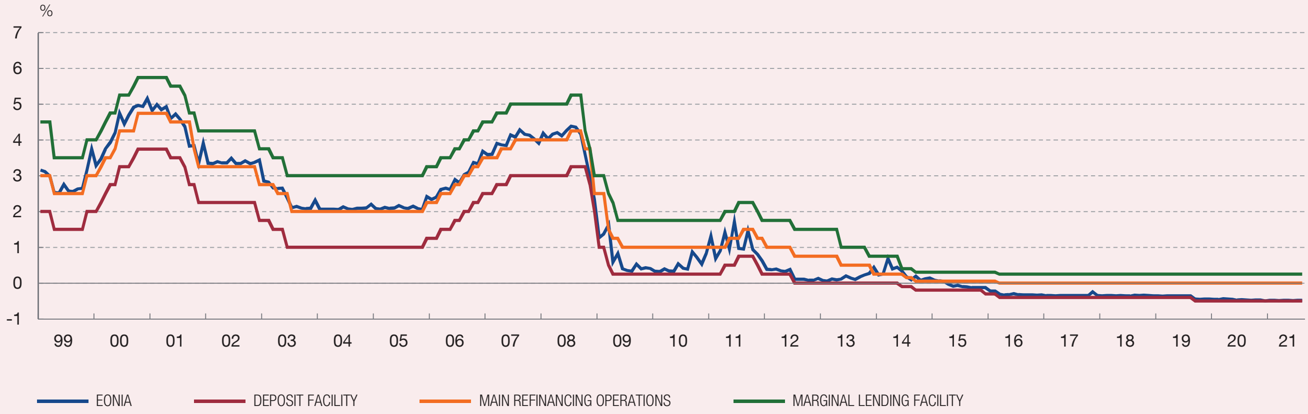
if considered necessary. As regards forward guidance, at the meeting of 22 July 2021, the Governing Council modified its formulation to adapt it to the new inflation target and, in general, to the new strategy. Specifically, the new forward guidance establishes that the Governing Council expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reach 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term.

As regards the measurement of inflation in the euro area, the new strategy confirms that the Harmonised Index of Consumer Prices (HICP) is the most appropriate indicator for assessing price stability. However, it recognises the advisability of including in the HICP some of the costs related to owner-occupied housing, insofar as they are indicative of the cost of the consumption basket of many households. For this reason, the ECB has recommended the inclusion of these costs in the HICP, a process that could take several years owing to the technical challenges involved. In the meantime, the new strategy establishes that, to supplement the HICP, the Governing Council, in its monetary policy assessments, will take into account other inflation measures that include estimates of the cost of owner-occupied housing.

Moreover, the ECB's Governing Council presented an ambitious action plan to continue incorporating climate change considerations into its monetary policy framework,[8] since climate change and the transition towards a more sustainable economy — a policy priority for the European Union —, affect, through multiple channels, both the outlook for price stability and the value and the risk profile of the assets held on the Eurosystem's balance sheet. With this action plan, the ECB is committed to strengthening its analytical capacity in macroeconomic modelling, statistics and monetary policy with regard to climate change, and to including climate-related considerations in monetary policy operations in relation to the disclosure of environmental sustainability information, risk assessment, corporate sector asset purchases and the collateral framework.

Lastly, the new strategy establishes that the documents and reports normally used for communicating the ECB's monetary policy decisions will be complemented by new communication instruments, with different layers of technical detail, geared towards different population segments.[9] Thus, the strategy aims to ensure that these decisions are better understood not only by experts but

Chart 1
EONIA AND KEY ECB INTEREST RATES (a)



SOURCE: Banco de España.

a End-of-period monthly data.

8 See ECB press release, "ECB presents action plan to include climate change considerations in its monetary policy strategy", of 8 July 2021.

9 See, for example, "Our monetary policy statement at a glance", of 22 July 2021.

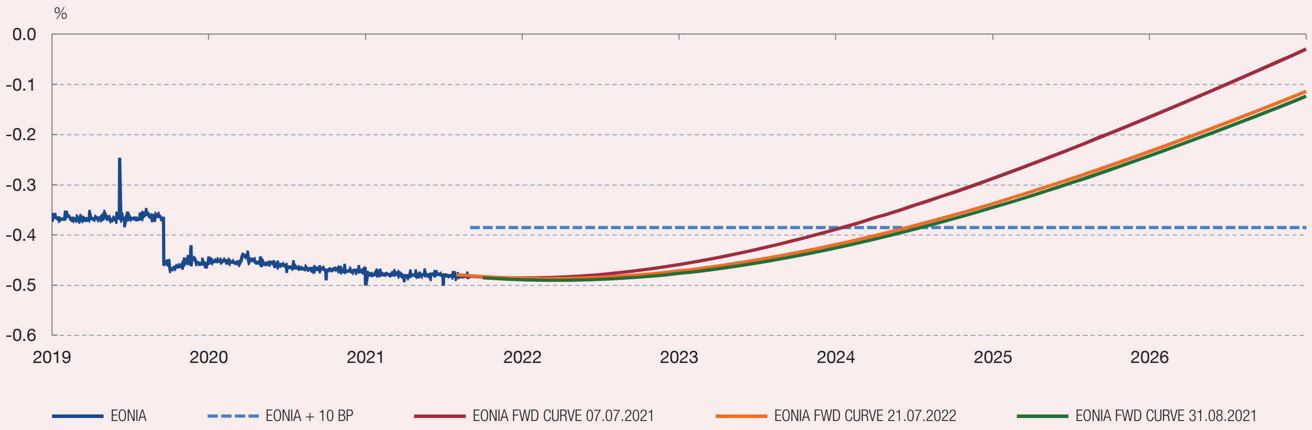
also by the general public. In the same vein, the ECB's Governing Council seeks to promote various initiatives to enhance the Eurosystem's interaction with the public.[10]

Turning to the response of the financial markets to the new monetary policy strategy, virtually no significant movements were observed in the key financial indicators on the day it was announced. This apparent lack of response could be interpreted as an indication that the announced review was essentially in line with the expectations of most financial market participants. It may also be consistent with the fact that investors need some time to fully adjust their monetary policy expectations to the new strategy, as observed following the announcement of similar strategic changes by other central banks in the past.

Accordingly, since the announcement, investors' expectations about the future path of interest rates and inflation in the euro area, proxied by their respective "forward curves"[11], have evolved as would be expected following the changes in the ECB's strategy and forward guidance. Thus, the EONIA instantaneous forward curve would indicate a delay in the expected date of the first increase in rates by the ECB (see Chart 2), while the inflation forward curve has shifted slightly upwards (see Chart 3). Both these developments would be consistent with the fact that the new strategy includes an inflation target which is somewhat higher than that previously envisaged and which removes any perceived asymmetry of the previous target, and the fact that the new forward guidance sets out more demanding conditions, in terms of adjusting inflation to the new target, for the ECB to start raising its interest rates. In any event, it is important to note that, in recent weeks, a number of macrofinancial, geopolitical and epidemiological developments also appear to have affected financial market behaviour and investor expectations. Therefore, in the absence of a more detailed analysis, the relationship between the aforementioned financial market movements and the announcement of the ECB's new strategy and forward guidance should be interpreted with due caution, particularly in terms of cause and effect.

In short, the ECB's monetary policy strategy review has warranted updating the inflation target and recognising the implications of the effective lower bound on interest rates when conducting monetary policy in the euro area.

Chart 2
OIS INSTANTANEOUS FORWARD CURVE



SOURCES: Refinitiv Datastream and Banco de España.

10 See the ECB's website for a more detailed description of the different listening events across the euro area.

11 The interest rate (inflation) forward curve is calculated on the basis of the prices quoted in interest rate (inflation) swap contracts and represents the interest rate (inflation rate) that should apply at a specified future date so that these contracts do not entail payments between parties. Forward curves are used to proxy investors' expectations about the future path of interest rates and inflation, albeit imperfectly, since forward rates incorporate risk premia. For euro area policy rates, the EONIA (Euro Overnight Index Average) forward curve is used. EONIA is an average interbank overnight rate which, since 2009, has remained very close to the ECB's deposit facility rate.

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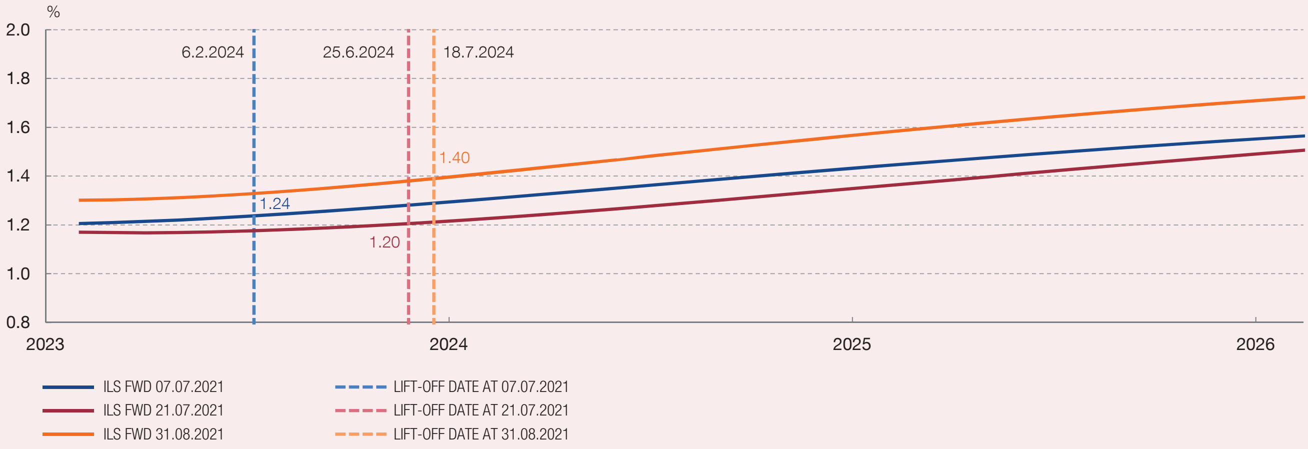
These new developments, along with the inclusion of more climate-related considerations in the institution's operational framework and the monitoring of owner-occupied housing costs, seek to improve the ECB's ability to fulfil its price stability mandate in the coming years. In any event, the ECB's Governing Council intends to assess periodically the appropriateness of its strategy, with the next assessment scheduled for 2025.

Chart 3
EURO AREA ILS FORWARD RATES AND EXPECTED LIFT-OFF DATE



SOURCE: Refinitiv Datastream and Banco de España.