The analysis behind the ECB's Strategy Review

By Adrian Penalver

In July 2021, the ECB announced a new monetary policy strategy. Behind the scenes, staff of the Eurosystem produced a comprehensive and detailed analysis to support the Governing Council. This blog summarises the main outcomes and will provide links to future blogs explaining the background material.

Source: European Central Bank

The ECB Strategy Review launched in January 2020 concluded in July 2021 with the announcement of a new strategy document, agreed unanimously by all members of the Governing Council. Over those 18 months, staff of the Eurosystem – including the Banque de France – were mobilised to examine the themes of the Strategy Review in depth. Their analysis was published in September in Occasional Papers available on the ECB website. Over coming weeks, we will publish a sequence of blogs to present the key discussions and analyses in each paper.

The ECB's previous Strategy Review was in 2003. Since then there have been a number of structural changes that have affected the way the euro area economy behaves and the effectiveness of using short-term nominal interest rates as the monetary policy instrument. For example, the path of inflation since the last review has been influenced by globalisation and digitalisation. Declining trend real output growth, which can be linked to slower productivity growth and demographic factors, and the legacy of the global financial crisis have also driven down equilibrium real interest rates. Since nominal interest rates have an effective lower bound (below which they cannot be cut further), the ECB has developed new instruments to provide monetary stimulus. The Review concluded that these instruments are effective and will continue to be used in the future, as appropriate.

The Treaty on the Functioning of the European Union states that the primary objective of the ECB is to maintain price stability. The Governing Council has decided that maintaining price stability is best achieved through a 2% symmetric inflation target over the medium term. At the same time, the Governing Council recognised that conventional monetary policy is particularly constrained by the effective lower bound on interest rates and that when close to this, monetary policy needs to be especially forceful or persistent to avoid negative deviations from the inflation target becoming entrenched. This may imply a transitory period in which inflation is moderately above target. Formal make-up strategies were also examined and their robustness to different modelling strategies and expectations formation were analysed. The Working Group on price stability also considered the possibility of using inflation bands to communicate about inflation volatility but this option was not adopted. The preferred inflation measure is the Harmonised Index of Consumer Prices but the Governing Council will also be presented in the future with measures that better reflect the cost of owner-occupied housing.

The Treaty also states that "without prejudice" to the primary objective, the ECB can contribute to other objectives of the European Union such as balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. The Eurosystem should also contribute to the stability of the financial system.

As required by the Treaty, the ECB must ensure the proportionality of its monetary policy decisions, including potential side effects. The Governing Council decided that an integrated assessment will be built on two interdependent analyses: an economic analysis and a monetary and financial analysis. In particular, they concluded that financial stability is a precondition for price stability. The challenges from the interaction of monetary and fiscal policy were also considered, particularly given the large expansion in central bank balance sheets since the start of the Covid crisis.

Climate change has profound implications for price stability and therefore its primary mandate. But it is also a secondary objective and the Governing Council announced its commitment to take into account the implications of climate change and the carbon transition for monetary policy and central banking. A particular challenge is how to incorporate climate risks into macroeconomic modelling and analysis.

Last but not least, the Governing Council committed to communicate more clearly and to a wider audience. This was considered essential to ensure public understanding and trust in the ECB which lies somewhat below trust in the euro itself. The Governing Council also intends to talk to and listen to the public more frequently.

The next Strategy Review is expected in 2025.