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The new ECB Strategy: What will change?

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Greater Clarity

On 8 July 2021 the ECB published its new Monetary Policy Strategy. Following the announcement, it is legitimate to ask what might change in the conduct of monetary policy in the Eurozone as it goes forward.

The immediate – intuitive – answer to the question is that no major change should be expected. The reason is that the new strategy is not that different from the previous one, although it is certainly clearer. Financial markets do not seem to have reacted significantly in any specific direction, although it may be too early to tell.

The main change concerns the definition of price stability, which is the primary objective of the ECB. At the start of the monetary union, the ECB defined price stability as an inflation rate of "below 2%". The definition changed in the 2003 Strategic Review to "below but close to 2%". It is now simply 2%.[1]

The clarification is certainly welcome, and it was advocated by many in the past,[2] given that there was still some margin of uncertainty about what was really meant by "below but close to". In the minds of most ECB policy makers the alleged "below but close to 2%" was in fact not significantly different from 2%. At his farewell event as ECB President, on 24 October 2011 Jean-Claude Trichet proudly reminded everyone that, "*The achievements of the Euro as a currency have to be judged against its primary mandate. Over nearly thirteen years, and in spite of a series of major global economic and financial shocks, average yearly inflation has remained at 2.0% for 332 million fellow citizens.*"

The other main element of the clarification is the symmetry of the new target. As explained in the ECB's explanatory document, *"symmetry in the inflation target means that the Governing Council considers negative and positive deviations of inflation from the target to be equally undesirable."*

Again, the issue of symmetry is not really a new one. In 2016, Mario Draghi reminded us that,*"it is equally important that we pursue our objective symmetrically."*[3] The ECB subsequently confirmed this view, for instance in the July 2019 Introductory Statement: *"Accordingly, if the medium-term inflation outlook continues to fall short of its aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim."*

[1] The inclusion of the owner-occupied housing index in the calculation of the HICP is another change that might have some impact, as suggested in "The rising cost of housing", by Daniel Gros and Farzaneh Samsfakhr, CEPS, 9 July 2021.

[2] See for instance *"Five Reforms the ECB should embrace"*, Lorenzo Bini Smaghi, Financial times, 15 October 2018.

[3] Speech for the 200th anniversary of the Oesterreichische Nationalbank, " June 2016.

To sum up, the substance does not seem to have changed much, but some clarification is welcome to avoid misunderstandings, especially at a time when inflation has been systematically below target for several years. It reduces, in particular, the risk of dis-anchoring inflation expectations from the 2% target.[4] It is also a way to discipline the communication of the ECB's policy makers, which in the past may have given a different interpretation to the words "close to 2%".

Ultimately, the key question is whether the new strategy will lead to a significant policy change compared to the past. The question is relevant, given that over the last 8 years the ECB has systematically missed its target, as inflation remained well below 2%. The main purpose of changing strategy, and now being more explicit about the 2% target, should be to reduce the risk of undershooting again, creating the conditions for the central bank to act more forcefully and more promptly when inflation projections deviate from the target. On this basis, one should conclude that if the new strategy had been adopted ten years ago, the ECB would have implemented a relatively more expansionary policy to make sure that the target would indeed be reached. This means that with the benefit of hindsight the ECB would have cut interest rates more promptly and implemented quantitative easing much earlier than 2015. This interpretation seems to be confirmed by a statement in the ECB document: *"This implies that faced with large adverse shocks the ECB's policy response will, as appropriate and based on a careful proportionality analysis, include an especially forceful use of its monetary policy instruments. In addition, closer to the effective lower bound, it may also call for a more persistent use of these instruments" (p. 4).*

However, …

A careful reading of the ECB document may raise some doubts about the above interpretation. For at least two reasons.

First, the ECB seems to suggest that a large part of the target undershooting in the past few years was the result of unforeseen economic developments, characterized by a series of disinflationary shocks, due in particular to the twin recessions following the great financial crisis, some deep structural trends (digitalisation, globalisation, demography), the evolving nature of financial structures (the rise in non-bank financial intermediation) and the insufficient support provided by fiscal policies. Furthermore, the attainment of the lower bound for policy rates compressed the margin for manoeuvre for monetary policy and affected the transmission mechanism.

It thus seems that, even with the benefit of hindsight, the ECB falls short of admitting that it could have done more to avoid missing the target and that it should have implemented an even more expansionary monetary policy throughout the entire period.

This is partly understandable for an institution. However, it is interesting to note that in its published documents the ECB generally tends to defend its policy decisions against the opposite criticism, that is, of having been too lax.[5] It is interesting because it should be quite obvious that a systematic inflation

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[4] *"Possible ambiguity about the level of the inflation aim under the ECB's double-key formulation of the objective and a perception of the objective as being asymmetric may have further contributed to the persistence of low inflation by insufficiently anchoring inflation expectations at levels below, but close to, two per cent."* Page 1, Overview of the ECB's monetary policy strategy, 8 July 2021.

[5] See for instance *"A Tale of two decades: The ECB's Monetary Policy at 20"*, By Massimo Rostagno and others, ECB working paper 2346, December 2019.

undershooting means that monetary policy was – if anything - too tight. Given that the strategic review finds *"that each of the instruments (including negative interest rates, forward guidance, asset purchases and longer-term refinancing operations) has been effective in raising output, employment and inflation, and that the different instruments have reinforced each other"*, it is legitimate to ask why, in light of such effectiveness, these instruments were not used more forcefully in the past to achieve the target.

This brings us to the second reason for concern. Two additional changes have been introduced in the strategy, changes that have not been publicised as much as the symmetric 2% target but that might be just as important. The first is the introduction of the principle of proportionality in the implementation of monetary policy. The second is the change in the concept of 'medium term', in which the target should be reached.

The principle of proportionality is mentioned with insistence in several paragraphs of the document, concerning, in particular, the need for the Governing Council *"to limit possible side effects of the new policy instruments and therefore [to] remain committed to continuing to perform careful proportionality assessments and to adapting the design of measures related to these instruments with a view to minimizing side effects, without compromising price stability" (p. 4).*

The reference to the principle of proportionality may be interpreted as lip service to the German Constitutional Court, following its 5 May 2020 ruling about the Asset Purchase Programme. It may also be an appropriate reference to the constrained environment in which the central bank operates at the lower bound, which leads it to combine different instruments such as (negative) interest rates, forward guidance, and asset purchases. Indeed, the combination of these instruments may require a careful assessment of their side effects with a view to avoiding unintended distortions and the impairment of the transmission channel of monetary policy.

However, there must be more to it in order to justify their being mentioned 8 times in the 7-page overview document. In fact, the ECB document dedicates a whole paragraph to explaining that proportionality has become an integral part of monetary policy decisions. Furthermore, it is striking that it comes right after the section on the medium-term orientation of monetary policy.

The ECB note states quite explicitly that, *"the medium-term orientation provides flexibility to take account of employment in response to economic shocks, giving rise to a temporary trade-off between short-term employment and inflation stabilisation without endangering medium-term price stability. It also allows the ECB to take account of financial stability, where appropriate, in view of the interdependence of price stability and financial stability. The use of such flexibility could also be the result of a careful proportionality assessment of the appropriate policy measures."*

This seems to be a substantial change from the past, for instance from the 2003 strategy evaluation.[6] The medium-term orientation was explained earlier by the fact that monetary policy operates with long and variable lags. If the central bank did not take these lags into consideration and tried to achieve the target at each point in time, it would tend to overreact, injecting instability into the system. This is the reason why the forecast horizon that central banks use for their decisions tends to coincide with the monetary policy lags. To be concrete, if monetary policy actions produce their effect on inflation with an 18-24-month lag, the central bank should take its decisions on the basis of the inflation forecast over the following 18-24 months. If, for

[6] "*The ECB's monetary policy strategy after the evaluation and clarification of May 2003"*, Speech by Jean-Claude Trichet, President of the European Central Bank, Frankfurt am Main, 20 November 2003.

instance, the anticipatory 18-24 month inflation forecast moves above 2%, one should expect the central bank to immediately start tightening the monetary stance, and vice versa if the forecast is below 2%.

In the ECB's strategy review the concept of medium-term orientation seems to be given a new meaning, in particular in conjunction with the principle of proportionality. The reference to the medium term is seen as a way for the central bank to take account of the trade-offs between the inflation objective and other macroeconomic variables, such as employment or financial stability, in deciding the monetary policy stance. The impression created is that the medium term may have become much longer than the horizon over which monetary policy produces its effects.

What are the implications for the conduct of monetary policy? This is not entirely clear.

One possibility may be that the central bank will aim at achieving the 2% target beyond the horizon of its policy effectiveness. For instance, if the economy experienced unexpected inflationary pressures and the central bank was required to raise interest rates to achieve its 2% target, it may decide not to do so immediately, or do less than required, if the tightening of monetary conditions produces disproportionate effects, such as a rise in unemployment or a financial disturbance. Inversely, the central bank may decide not to act forcefully to counter an inflation rate below 2% if the actions required to achieve this goal produce undesired effects, for instance in terms of asset price dynamics.

The way in which the proportionality assessment is described in the ECB's document may lead us to think that the ECB may not always stand ready to act promptly and forcefully whenever that is needed to achieve the 2% target. The central bank may be willing to tolerate inflation above or below the 2% target for much longer than before.

This view is not surprising. It was explicitly supported by some ECB Governing Council members, with a view to justifying an inflation rate persistently lower than 2% without the need for taking additional monetary policy measures.[7]

If the new interpretation is correct, it is not without consequences for the conduct of monetary policy.[8] It may also raise a whole series of issues for the central bank, concerning in particular its transparency, accountability and even independence. Who decides, and on which basis, whether a given policy is proportionate or not, whether the length of the deviation from the target is adequate, what side effects are relevant or not? Does the ECB have the legitimacy to make such a judgment, since it concerns macroeconomic variables that are not under its remit? If pushed to the extreme, the implementation of the principle of proportionality advocated by the German Constitutional Court may become a major threat for the independence of the ECB, and possibly for the euro, as I argued elsewhere.[9]

To sum up, the new ECB Strategy provides clarity concerning its inflation objective by specifying the 2% target and making explicit reference to symmetry, but it may have introduced some elements of uncertainty that require further explanations. Indeed, the insistence on proportionality and on the medium-term trade-offs can

[7] See for instance "*The quest for policy scope - implications for monetary policy strategies*" Klaas Knot, Fourth annual high-level conference "Racing for Economic Leadership: EU-US Perspectives", New York City, 16 October 2019 and, "*Monetary policy: lifting the veil of effectiveness*", Benoit Coeuré, ECB colloquium "Monetary policy: the challenges ahead", Frankfurt am Main, 18 December 2019.

[8] *"Is the ECB at risk of becoming an underachiever?"* Lorenzo Bini Smaghi, SEP Policy Brief 1/2020, 10 January 2020.

[9] *"The Judgment of the German Constitutional Court is incomprehensible"*, Lorenzo Bini Smaghi, SEP Policy Brief 25/2020, 15 May 2020.

be interpreted as a certain reluctance to carry out monetary policy actions in a prompt and forceful way to achieve the 2% target.

Let's consider, as an example of the possible uncertainties that may arise from the new strategy, the first monetary policy decision announced on 22 July 2021. The ECB announced that it would keep interest rates unchanged, or even lower, as long as inflation does not reach 2% within the forecast horizon, in a durable manner. This is consistent with the symmetric approach to the new target. It suggests that the ECB is even ready to tolerate, as announced, an inflation rate above 2% for a certain period of time. Christine Lagarde made it clear during the press conference.

On the other hand, given that inflation is not currently projected to reach the 2% target within the forecast horizon, it is not clear what the ECB intends to do to achieve the objective. The new forward guidance is clearly not enough. Why hasn't the ECB taken other measures to support its strategic commitment to acting promptly to achieve its target? Does this have to do with the fact that the concept of the 'medium term' has changed, as mentioned above? In the Q&A section, the ECB President responded: *"The medium-term horizon is probably a little beyond that [the projection horizon] and is also helping us take into account other matters that have nothing to do with inflation calculation, but which have to do with employment, with climate change, with factors that we have to take into account, but that are not specifically driven to inflation, and our inflation forecast."* The Pandora's box might have just been opened. How the ECB will "*take account of other matters*" will become one of the key factors for understanding its new policy strategy. What seems to emerge from the July 22 decision is that the ECB is willing to tolerate an inflation rate of below 2% for a longer period of time.

These issues are relevant to the extent that the post-Covid world may present challenges that are not that different from the pre-Covid world. Indeed, the main forces underlying the deflationary environment, characterised by excess savings over investment, and a clogged monetary policy transmission that the ECB mentions in its review are likely to persist. It is not clear how these challenges will be addressed. Two challenges, however, are particularly relevant.

What about the Policy Mix?..

The first issue concerns the mix of monetary and fiscal policies in the Eurozone. Central bank independence requires that monetary policy be implemented with a view to achieving price stability, taking fiscal policy as a given. However, the fiscal policy stance directly affects the way in which monetary policy achieves its objective. There is a broad consensus that in the pre-Covid years fiscal policy was insufficiently supportive of economic growth in the Eurozone, producing excess savings and thus increasing the burden on the central bank to be overly expansionary. Mario Draghi and later Christine Lagarde repeatedly called for a more supportive fiscal policy, especially in countries that had sufficient room for manoeuvre. However, these calls were largely unheeded, and the overly restrictive Eurozone fiscal stance contributed to enhancing deflationary pressures in the Eurozone.

Between 2013 and 2019, the overall Eurozone fiscal stance tightened, moving from a primary deficit of 0.6% of GDP to a surplus 0.8%, while in the same period the US primary deficit increased from 2.6% of GDP to 3.4%. The aggregate Eurozone debt decreased from 93% of GDP to 84%; in the US the public debt increased from 104% to 107% of GDP, while maintaining a triple A rating, higher than the average European debt.

The divergence was even bigger within the Eurozone. In the above-mentioned period, Germany systematically recorded a budget surplus as a result of its new constitutional rule, which contributed to reducing the public debt from 79% of GDP in 2013 to below 60% in 2019. In France, instead, the debt stabilised around 98% and in Italy around 134%.

The relatively tighter fiscal policy in the Eurozone led to a more accommodative monetary policy compared to the US. While the Fed raised its policy rate by 2.25 points between 2015 and 2019 and decreased the size of its balance sheet, the ECB, instead, further cut its interest rate into negative territory and started its Asset Purchase Programme. The combination of these policies pushed the long-term interest rates on the European safest asset, i.e. the German bund, to -0.5% in 2019, from 2% in 2013.

The post-Covid scenario is unlikely to be much different. Despite the uncertainties surrounding budgetary programs for the coming years, it is highly probable that some countries, in particular Germany, will start implementing a tighter fiscal policy earlier than others, in particular those with higher debt and lower growth. The combination of excess savings over investment in the whole Eurozone and the divergent debt dynamics across countries are expected to continue. The overall deflationary pressure will remain, making it difficult for the central bank to achieve the 2% inflation target.

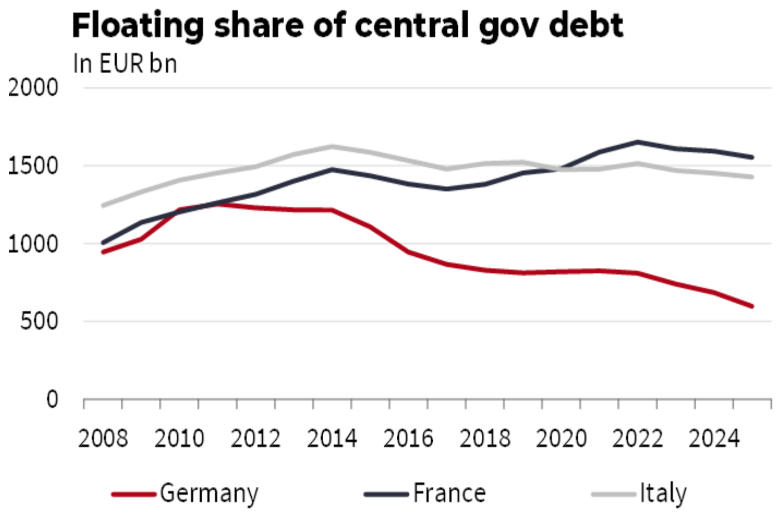
If this scenario is confirmed, how will the new strategy make a difference? Will the ECB act more promptly than in the past, in particular through its APP, with a view to increasing the monetary stimulus, or will it extend the medium-term horizon to tolerate lower inflation for a longer period of time? How will the principle of proportionality be taken into consideration, if the continued monetary accommodation has led to some asset price inflation or other forms of financial instability?

One interesting issue relates to the proportionality of the instruments used by the ECB, in particular the APP and the way it is implemented.

The following chart shows the amount of government debt floating in the market, which excludes central banks' holdings from the overall stock. It is well known that the European System of Central Banks implements its Asset Purchase Programme on the basis of the ECB's capital key, calculated using the countries' population and GDP (Germany 26.4%, France 20.5%, Italy 17%). Less than 10% of the revenues are shared.

The impact of the ECB's policy is not market-neutral, given that the relative share of the purchased assets differs from that of the existing stock of assets. In other words, central banks purchase relatively more German bunds than Italian or French bonds, while the available stock of the latter two is higher. This means that, all other things being equal, central bank purchases tend to affect the relative price of German vs Italian bonds and German vs French bonds.[10] This effect has been magnified prior to the crisis by the fact that the overall supply of German bunds fell, year after year, as a result of the German budget surplus, while that of Italian or French bonds increased.

[10] This does not mean that, as designed, the APP widens the spread between German Bunds and Italian BTPs, given that the additional central bank liquidity ultimately flows towards the higher yield assets, but rather that the compression of the spread is lower the higher the share of low yield assets in that APP.



The continuation of the current policy, even after the expiration of the Pandemic window of the APP, which is simulated in the chart, suggests that the distortionary effect is likely to continue in the coming years and may even worsen. The quick reactivation of the *swarz nul* constraint on the German budget will further reduce the stock of marketable German bunds in the coming years. It is estimated that the overall amount of outstanding bunds might fall by over 50% in 2025, compared to the start of quantitative easing, in 2015. In the meantime, the stock of marketable French and Italian debt is expected to remain broadly constant, at a level 3 times higher than the German debt. This is likely to put further downward pressure on German yields, compared to the others, with relevant effects for investors such as insurance companies or investment funds.

There can be several ways to reduce the distortion. The first one is to disconnect the asset purchase program from the capital key in a more systematic way, as was done during the pandemic. However, this could affect the relative revenues of the different ECB shareholders. The second way is to change the agreement among the national central banks concerning the sharing of revenues and risks of the assets purchased under the APP. A full risk sharing, for instance, would enable to reduce a country's purchased share of assets without reducing the revenue stream for the national central banks. The alternative is to decelerate or even stop the APP, as suggested by some, in light of the distortionary collateral effects, especially on the price of German bunds, although this could imply accepting a protracted deviation from the 2% target, which may be in contradiction with the new strategy announced.

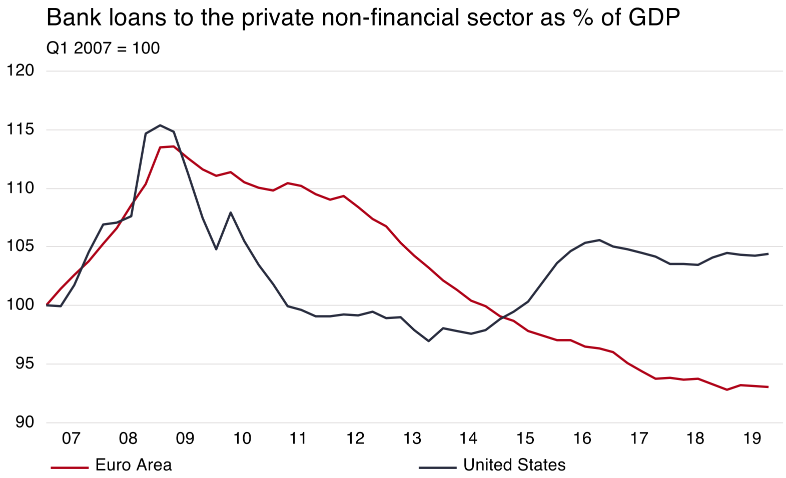
It will be difficult for the ECB to avoid such a discussion.

… and the transmission mechanism?

The second issue that the ECB will need to tackle is the transmission mechanism of monetary policy. The central element of this mechanism is the banking sector, as over 70% of the lending to corporates and households in the Eurozone comes from the banking system. This is significantly different than in the US, where the largest share of financing takes place through the capital market.

In the period between the 2008-09 great financial crisis and the 2020 Covid crisis, the European banking system underwent a major transformation that has impacted its ability to transmit the changes in the monetary policy stance to the real economy.

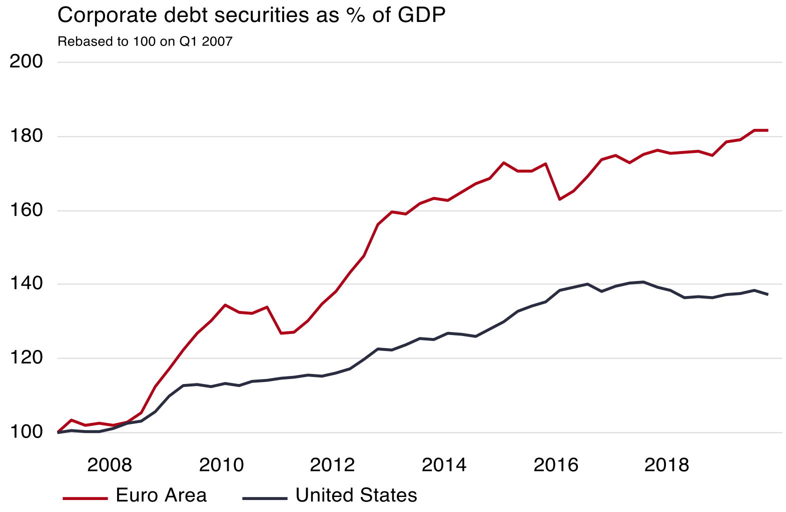
The share of Eurozone bank financing over GDP continued to decrease from 2008 to 2019, while it recovered in the US to levels higher than in 2007.



This may have been partly due to a relatively slower demand in the Eurozone. However, this explanation doesn't entirely match the evidence concerning non-bank financing, which was actually more dynamic in Europe than in the US, as shown in the following chart. In fact, capital market financing experienced strong growth in Europe, but the relatively small size of the market did not compensate for the stagnant banking flows.

This suggests, on the one hand, that there is a strong demand for a more integrated capital market in Europe but also, on the other hand, that the banking system may not be entirely capable of transmitting the desired monetary policy impulse in order to support economic growth as intended.

Part of the explanation derives from the adjustment that the European banking system experienced after the great financial crisis, which was slower compared to the US. Lower profitability led to less capital accumulation and, therefore, the adjustment of capital and leverage ratios in Europe mainly took place through a compression of risk weighted assets.



The main issue is whether these factors will continue to play a role in the post-Covid environment. This is likely to be the case for some key parameters, which are not independent from the way in which the ECB implements its monetary policy. The first is the negative level of the deposit rate, which amounts to a tax on the banking system that is only partly compensated by the tiering system and the favourable conditions for applying for TLTRO. Such a tax reduces banks' profitability and thus the ability to set aside fresh capital with a view to supporting new lending. Evidence also suggests that the initial positive effects of the negative rates on the credit risk tend to be compensated over time by the negative consequences.[11] The negative effects rise in line with the size of bank deposits resulting from the central bank's asset purchase.

An additional negative impact of the asset purchase program on banks' net income is the increase in the yearly contributions to the Single Resolution Fund, which are calculated in proportion to banks' deposits that rise in line with the size of the central bank's balance sheet. The rise in bank deposits also creates additional constraints in terms of banks' leverage ratios and Asset-Liability management, which further burden banks' ability to lend, creating the crowding out risk for the economy.[12]

Finally, the remaining uncertainties concerning the impact of the Basel implementation and whether additional requirements are to be expected, for instance concerning the impacts of climate change, creates an incentive for banks to be very prudent about using their capital, possibly preferring to buy back shares rather than increase lending.

Interestingly, the interaction between the above-mentioned structural factors and the implementation of monetary policy tends to create a vicious circle. Indeed, the more the traditional banking channel appears to be clogged, the more the central bank is incentivised to inject liquidity through other channels, in particular the capital market and asset purchases, which however contributes to further weakening the banking channel. In addition to the effects mentioned above, produced by the negative deposit rate, the regulatory requirements

[11] "*The reversal Interest Rate*", by Markus Brunnermeier and Yann Koby, Princeton University, January 2021.

[12] "*The crowding out risk for the economy*", Michala Marcussen, Financial times, 7 May 2021.

and the SRF contributions, the flattening of the yield curve resulting from the combination of negative policy rates and the asset purchase further contribute to reducing the profitability of the traditional banking business.

How will the ECB address these issues, in particular those concerning proportionality? Will it ignore them or will it instead try to change the combination of policy instruments to reduce the inherent distortionary effects? Will it consider the collateral effects as an argument to attenuate the monetary policy stance, thereby tolerating a longer deviation from the 2% target?

The ECB will face these questions sooner rather than later. As for any pudding, the proof of the ECB's revised monetary policy strategy will be in the eating.