Central Banks

ECB Strategy Review: 2% and mindful of climate change

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- **In its new strategy review, the ECB adopts a symmetric 2% target, as expected. This is a moderate but welcome change**
- **Interest rates will remain the primary tool, while "non-standard" measures will be part of the monetary policy toolkit, though no details are provided**
- **The ECB firmly commits to climate change in the conduct of its monetary policy**

The ECB today announced the awaited results of the Strategy Review, though earlier than expected (July and not September), probably to avoid mixing this debate with the one on the phasing out of PEPP after the summer. The review was long overdue, with the previous one held in 2003; now the ECB has committed to do it more often -the next one in 2025. The new strategy was **approved by unanimity**, though probably at the cost of lack of commitment in some areas, as we will see.

On the monetary policy side, the most significant but not surprising change is the modification to its inflation target to a **'symmetric 2% target'** over the medium term, which is easier to communicate that the previous definition of price stability of 'below, but close to, 2%', which was slightly more hawkish as the 2% was perceived as a ceiling, dampening inflation expectations, and introduced a disinflationary bias. In Lagarde's words, the new target is "neither a ceiling nor a floor".

President Lagarde clarified that "symmetric" means that deviations on either side are "equally undesirable" but that they would allow moderate deviations. However, pointing to the (very low) inflation environment over the past years, she recognized that the current Effective Lower Bound (ELB) constituted a constraint and the **ECB will have to take specific actions and "act forcefully" to avoid negative deviations** that pose a risk of entrenching inflation expectations. She also made clear that the **ECB's new inflation target differed from the Fed's "Flexible Average Inflation Target (FAIT)"**, which in practice targets an average inflation over an (unspecified) period. That is, the ECB will not compensate periods of undershooting with periods of overshooting. In our view, it would have been difficult for the ECB to set an average target retrospectively given that the Eurozone average annual inflation during the last 10 years was 1.2%, which would have required a very long period of accommodation to achieve overshooting. In addition, the lack of clarity of Fed's FAIT on the specific time window to measure average inflation has also been criticized as a potential source of inflation volatility overtime.

Overall, the target change **represents a structural dovish shift in monetary policy, but is small and not as dovish as the Fed's.** Other, bolder measures, such as raising the target to allow more distance from the zero lower bound were not even discussed. The new target is in any case clearer and easier to communicate than the previous one, and its "symmetry" will allow the ECB to gain some discretion in the implementation of monetary policy.

Another change that is related to the target is the ECB's recommendation to include Owner Occupied Housing (**OOH) costs in the measurement of HICP (which is retained as the target inflation definition). This was also expected, but the ECB recognizes it will take years for Eurostat to develop it**. During the **transition** period, the HICP will remain the principal measure but OOH indicators will play a supplementary role alongside broader inflation measures. The impact of such a new component on inflation is small but positive (around 0.2% according to previous ECB calculations), adding a small hawkish bias to monetary policy.

On the monetary policy instruments "nonstandard measures", which have been abundantly used in recent years but only as "extraordinary", **will become an integral part of the ECB's normal toolkit.** This announcement was widely expected as given the risk of asymmetric shocks across member states, the ECB will provide itself with sufficiently flexible instruments at its disposal in order to avoid the re-emergence of fragmentation dynamics and the impairment of monetary policy transmission across the euro area. **Nonetheless, the ECB emphasized that interest rates will remain the primary tool for monetary policy, with other tools such as forward guidance, asset purchases and longer-term refinancing operations helping mitigate the policy limitations stemming from interest rates at the lower bound.** Moreover, the ECB made clear that in making monetary policy decisions, the GC systematically assesses the **proportionality of its measures,** which includes an analysis of the benefits and the possible side effects of monetary policy measures, their interaction and their balance over time. This principle of proportionality may put a break on bold steps, but at the same time is a preemptive measure to avoid challenges from the German Constitutional Court.

Still, while this announcement was within the bets, **it would have been useful if they had complemented the strategy publication with guidelines - details about which instruments and how they will be implemented in the future - regarding the use of "non-standard measures"**. Should the ECB resort to such measures not only in exceptional periods, but also in normal times, it should be clear when, how and to what extent some of the instruments would be integrated into the permanent toolbox. In particular, as the asset purchases will continue to be a key policy tool, with the PEPP ending in 1H22 and the APP as the only program in place, the ECB could have been more explicit on the details of QE in "normal times", or the conditions under which extraordinary programmes (such as the PEPP, which has higher flexibility) could be used.

Finally, the issue they were most explicit on was climate change as the Governing Council (GC) approved an ambitious climate change action plan. **In a bolder than expected move, the strategy review brought to the fore the ECB's firm commitment to climate change considerations** in the conduct of its monetary policy. It acknowledged that physical and transition risks related to climate change have implications for both price and financial stability, and affect the value and the risk profile of the assets held on the Eurosystem's balance sheet. The review outlined a **comprehensive action plan, with an ambitious roadmap** that covers key areas of ongoing and planned actions by the ECB to more systematically reflect climate change considerations in its monetary policy operations, including the adaption of the design of ECB's monetary policy operational framework in relation to inclusion of climate change considerations in **disclosure, risk assessment, collateral framework and corporate sector asset purchases**. Looking into the future, President Lagarde projected that the ECB could enforce strict climate-related disclosures for bonds and collaterals as a part of the eligibility criteria for its asset purchase programs. That said, **the ECB acknowledged that an important part of the climate change action plan involves Eurosystem reliance on external developments**, and thus incorporates inherent uncertainties. This includes **the implementation of measures related to adoption of EU disclosures regulations**. Finally, on the potential implications of climate change on inflation, Mrs Lagarde admitted that the jury was divided, and that the ECB has not concluded on either side of this proposition, although **the ECB is inclined to believe that the green transition would not result in accelerating inflation pressures going forward**.

To conclude, the strategy review has been in the end relatively moderate, introducing the welcome change of target to a symmetric and clearer one (2%) and adopting as permanent the toolkit of instruments that has been used for several years now (though with few details). The change has been less ambitious than the one by the Fed, as one might expect. On climate change, the ECB is clearly more committed to specific action, but depends on other institutions.

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