

28 JUL 2021

## The ECB's new monetary policy strategy leaves more questions unanswered than it resolves

The European Central Bank recently communicated its new monetary policy strategy. The first strategic realignment since May 2003, however, disappoints expectations on several fronts



Why was a review of the ECB's monetary policy strategy necessary in the first place? First and foremost, two issues had to be addressed that are directly related to the ECB's primary goal - price stability -, namely, the numerical definition of price stability and the price index to be used for this purpose.

On the numerical target: The goal formulated in 2003 ("an inflation rate below but close to two percent") left the central point undetermined and was asymmetric, hinting that the ECB cared more about too high than about too low inflation. In the age of looming deflation, this needed to be corrected.

The composition of the price index was also a problem, due to the exclusion of a key component of the real cost of living: the cost of owner-occupied housing (OOH).

The newly presented strategy only solves the targeting problem, and even that only partially. The new central target, two percent with a symmetric but unspecified range around it, offers no clue to what deviation the ECB is willing to tolerate. This is likely to complicate the ECB Council's discussions going forward, perhaps as early as in the coming weeks.

### There are two problems

On the appropriate price index which serves as the basis for the two percent target, the ECB press release states that "[...] the Governing Council recognises that the inclusion of the costs related to owner-occupied housing in the Harmonised Index of Consumer Prices (HICP) would better represent the inflation rate that is relevant for households." This recognition is welcome and overdue. But there are two problems.

First, the inclusion of OOH costs is announced as a multi-year project of unspecified duration. What will happen in the meantime? Will the ECB Council already adjust its focus in an informal way? In light of increasing housing prices and rents, the inclusion of OOH may, based on available information, move the inflation index up by at least 0.4 percent. The "below but close" formulation was generally regarded as meaning an effective target at 1.8 percent. A two percent target with OOH included would thus be more restrictive than the present HICP target without OOH.

However, the second, more fundamental problem of how to interpret inflation dynamics seems not to have been addressed. At least, no technical studies have been published or announced, for example of the kind that were conducted for the earlier strategy review in 2003. Detailed empirical studies are needed to address this problem and to guide the ECB's approach going forward.

A fundamental question begs an answer: Why has inflation remained stubbornly low in spite of a nearly decade-long extraordinary monetary expansion? Inflation has been averaging 1.5 percent since 2003 and has been especially below the target since 2014, when asset price increases and other "unconventional measures" were intensified.

### More formality than substance

Over the same period unemployment has fallen steadily by four percentage points. What has happened to inflation dynamics and to the monetary policy transmission mechanism?

There is one other issue that nobody anticipated in 2003, namely, the risk to the euro itself. Ever since the euro crisis, the ECB has struggled to “preserve the euro”, per Mario Draghi on 26 July 2012, that is, to fend off the centrifugal forces between core and peripheral countries that occasionally put the cohesion of the monetary union at risk. The tensions which flared up at the height of the financial market turbulences in early 2020 show that these tensions between core and periphery can happen at any time again. Unfortunately, the review does not recognise this problem and is silent on whether and how the ECB will handle it in the future.

In this new strategy the ECB seems intent on venturing into new territory by including climate change as a key part of its strategy.

But this is more formality than substance. This is because the new strategy only describes the impact of climate change on price stability and its implications for banking supervision. However, these were – at least in principle – already covered by the previous approach. No strategy review was needed; perhaps only a refinement of the analytical tools. The issue that needed and still needs clarification is the extent to and the way in which the ECB pursues “secondary objectives”, that is, objectives unrelated to the ECB’s inflation goal which may enter monetary policy decisions without prejudice for the attainment of that goal, as the EU Treaty requires. This question – which incidentally does not only involve climate change – does not seem to have received an explicit answer yet.

The new strategy of the ECB does not fulfil the essential task of providing decisive answers to open questions.

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*This article was originally published in a longer version on [VoxEU.org](https://voxeu.org) on 16 July 2021 and in the German newspaper “Börsen-Zeitung” on 23 July 2021.*



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