SPEECH

The monetary policy strategy of the ECB: the playbook for monetary policy decisions

Speech by Philip R. Lane, Member of the Executive Board of the ECB, at the Hertie School, Berlin

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I welcome the invitation to speak at the Hertie School, which has such a strong record in European public policy research, including research on the institutional architecture of the euro area. I especially wish to acknowledge the exceptional contributions of the late Professor Henrik Enderlein, who played a founding role in the development of the Jacques Delors Centre.

Before turning to the topic of today's lecture, I wish to comment on the Russian invasion of Ukraine. At stated by President Lagarde last Friday, at this dark moment for Europe, the thoughts of the ECB's Governing Council are with the people of Ukraine. The ECB is closely monitoring the evolving situation. With regard to policy measures, the ECB will implement the sanctions decided by the EU and the European governments. The ECB will also ensure smooth liquidity conditions and the access of citizens to cash. The ECB stands ready to take whatever action is needed to fulfil its responsibilities to ensure price stability and financial stability in the euro area.

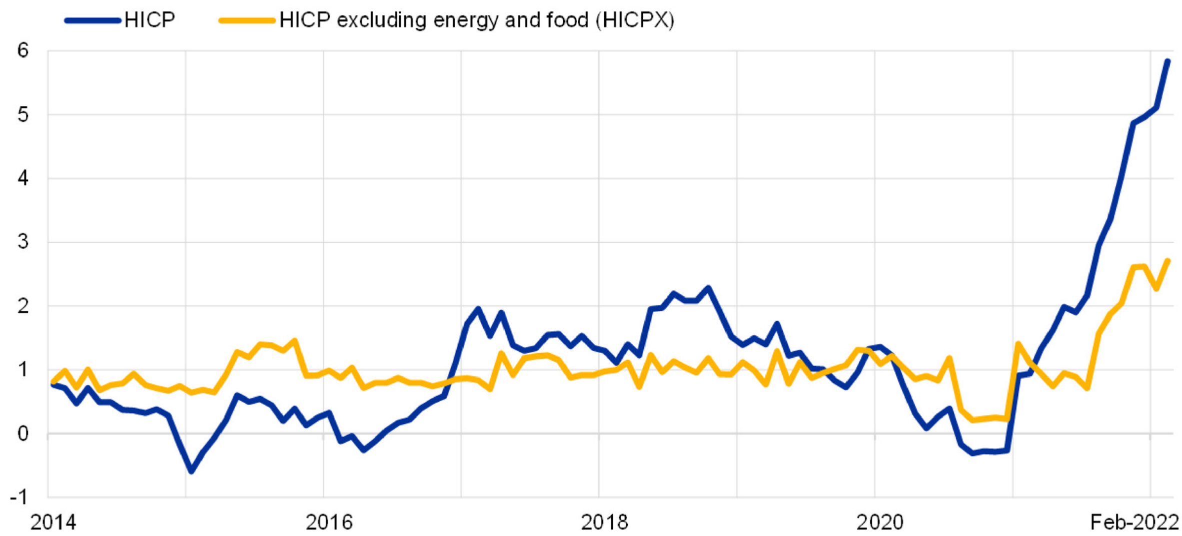
Today, I wish to frame the current monetary policy debate in the context of the monetary policy strategy of the ECB.[1] I will not dwell on the latest conjunctural developments or speculate on the evolution of the medium-term outlook for the economy and inflation. Our monetary policy meeting next week will provide the best opportunity for a comprehensive assessment of economic and financial developments and the implications for near-term and medium-term inflation dynamics. In this respect, the schedule for the March staff projections exercise has been revised in order to take into account the implications of the Russian invasion of Ukraine. The revised schedule also means that today's Eurostat inflation release will be incorporated in the projections that will be considered at next week's monetary policy meeting.

Chart 1 provides some empirical context for the discussion by showing the evolution of headline and core inflation since 2014. It underlines that, until quite recently, the euro area has been confronted with a low-inflation problem, with inflation persistently well below two per cent. At the same time, Chart 1 also shows the sharp increase in inflation in recent months. The flash inflation estimate for February that was published today stands at 5.8 per cent. The upward pressure on overall inflation from the extraordinary 31.7 per cent rate of energy inflation is operating through both direct and indirect channels, since the increases in the sectoral inflation rates for food, goods and services in part reflect the impact of higher energy prices for production costs in all sectors of the economy. In recent weeks, I have emphasised that much of the sharp increase in the last six months can be attributed to the large-scale shock to energy prices and pandemic-related factors (including supply bottlenecks).[2] In any event, it is essential for a central bank to ensure that its monetary policy stance fully takes into account the implications of the shift in the inflation environment.

Chart 1

Headline and core inflation in the euro area

(annual percentage changes)



Sources: Eurostat and ECB.

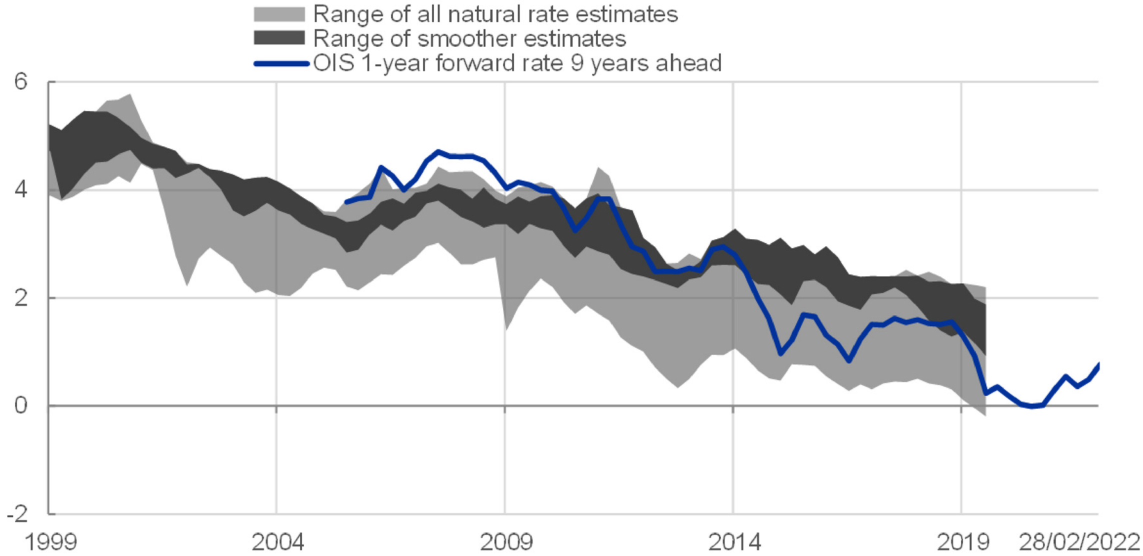
Note: The latest observations are for February 2022 (flash release).

Chart 2 shows the dynamics since 1999 of the estimated equilibrium nominal interest rate, which is constructed as the sum of the two per cent inflation target and the equilibrium real interest rate, which is the real interest rate that is consistent with full utilisation of available resources and inflation steady at the target. The trend decline in equilibrium interest rates was a first-order issue in the strategy review exercise. In particular, a low equilibrium interest rate means that any robust monetary policy strategy must take into account the effective lower bound on policy rates.

Chart 2

Econometric estimates of the euro area nominal natural rate of interest r*

(percentage per annum)



Sources: WGEM Report "The natural rate of interest: estimates, drivers, and challenges to monetary policy", Occasional Paper, No 217; Ajevskis (2020); Brand, Goy, Lemke (2020); Brand, Mazelis (2019); Fiorentini, Galesi, Pérez-Quirós, Sentana (2018); Geiger and Schupp (2018); Holston, Laubach, Williams (2017); Jarocinski (2017); Johannsen and Mertens (2021), Refinitiv.

Notes: The natural nominal rate estimates are constructed by adding the inflation target of 2% to all real values. Ranges span point estimates across models to reflect model uncertainty and no other source of r* uncertainty. The dark shaded area highlights smoother r* estimates that are statistically less affected by cyclical movements in the real rate of interest than the other estimates depicted in the chart.

Last observation: 28 February 2022 for the OIS 1-year forward rate 9 years ahead (reporting average values over the quarter).

A monetary policy strategy serves two main purposes: first, it provides policymakers with a coherent analytical framework that maps actual or expected economic developments into policy decisions; and, second, it serves as a tool for communicating with the public. A strategic approach to monetary policy is especially valuable when confronted with possible shifts in the underlying forces shaping inflation dynamics. Rather than policymakers having to search in the dark for the appropriate policy response, a robust monetary policy strategy provides policymakers with the playbook for handling a wide range of scenarios.

The extensive Eurosystem monetary policy strategy review exercise during 2020 and 2021 considered a vast array of factors relevant for the conduct of monetary policy: the work of the Eurosystem staff was organised into thirteen workstreams and their many individual background notes are synthesised in the 18 Occasional Papers released in autumn 2021. Of course, the strategy review did not start from scratch: there was much to retain from the earlier phases in the development of the ECB's monetary policy strategy, both in terms of the initial design in 1998 and the review in 2003.

Rather than trying to provide a comprehensive overview of all of the dimensions of the entire strategy review, I will focus today on the guidance it provides for the conduct of monetary policy in pursuit of the two per cent inflation target over the medium term.

The new strategy takes a symmetric perspective on deviations from the two per cent target: overshoots and undershoots are equally undesirable. The focal point provided by the two per cent target makes for clearer communication. This is in line with a fundamental conclusion of the strategy review, which identified a simpler communication style as highly desirable. In addition to providing a stronger anchor for inflation expectations, a strategic commitment to simplifying the communication of monetary policy also makes it easier for the ECB to be held accountable and for it to build trust among the general public.

Regarding the symmetry of the inflation target, the recognition that deviations from the target in either direction are equally undesirable implies that a risk-management approach to the calibration of monetary policy should balance equally the risks of inflation being too high and too low. At the same time, the symmetry of the target does not necessarily imply symmetry in policy responses to these risks, in view of the constraints imposed by the effective lower bound in reacting to below-target inflation.

As to the policy instruments that can be deployed, the set of policy interest rates takes primacy and should be sufficient to deliver the two per cent target in scenarios in which the economy is not operating in the shadow of the effective lower bound and in which financial conditions are non-stressed. However, when the economy is close to the lower bound (either as a result of a sequence of adverse shocks or simply due to a sufficiently-low equilibrium real interest rate such that even the steady-state nominal interest rate is close to the lower bound), the strategy review concluded that monetary policy measures should be especially forceful or persistent to avoid negative deviations from the inflation target becoming entrenched. Moreover, adopting forceful or persistent measures may also imply a transitory period in which inflation is moderately above target, since a persistently-accommodative stance that successfully lifts inflation towards the target may involve hump-shaped adjustment dynamics for the inflation path. In particular, maintaining some policy measures on a persistent basis acknowledges that a commitment to maintaining monetary policy accommodation into the future can partially substitute for sharper near-term policy easing measures.

The forward guidance provided by the ECB on asset purchases and interest rates reflects the instrument hierarchy outlined in the strategy review. In relation to net asset purchases under the asset purchase programme (APP), the forward guidance is that these will be maintained for as long as necessary to reinforce the accommodative impact of policy rates and that these are expected to end shortly before the key ECB interest rates are raised. This forward guidance clearly expresses that net asset purchases are designed to supplement the primary role of the set of policy rates (in recognition of the limitations associated with the effective lower bound) but that net asset purchases would cease if the inflation environment no longer required the accommodative impact of policy rates to be reinforced. Moreover, this also implies a clear sequencing: the end date for net asset purchases is naturally earlier than the date at which it would be appropriate to raise the key policy rates. Introduced in September 2019, the guidance that net asset purchases are expected to end only shortly before the key ECB interest rates are raised provides the reassurance that net asset purchases would not be prematurely terminated.

In relation to interest rate forward guidance, three key conditions should be met before interest rates are raised:

The first condition "*until we see inflation reaching two per cent well ahead of the end of our projection horizon*" provides reassurance that the convergence of inflation towards the new target should be sufficiently advanced and mature at the time of policy rate lift off. Moreover, requiring the inflation target to be reached "*well ahead of the end of the projection horizon*" helps to hedge monetary policy against the risk of relying excessively on inflation projections at the long-end of the projection horizon, where forecast errors tend to be larger under typical conditions.[3]

The second condition -- that we expect inflation to reach two per cent not only well ahead of the end of the projection horizon but also "*durably for the rest of the projection horizon*" -- telegraphs that inflation reaching the target should be lasting and not just be the result of short-lived forces that lead to one-time increases in prices that are unlikely to lead to persistently higher year-over-year inflation.

The third condition, which requires "*progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term*", signals that policy rates should not be lifted unless underlying inflation is also judged to have made satisfactory progress towards the target. This condition is based on realised data and provides an extra safeguard against a policy tightening in the face of cost-push shocks that might elevate headline inflation temporarily but fade within the projection horizon.

It is important to recognise that underlying inflation is a broad concept and refers to the persistent component of inflation that filters out short-lived movements in the inflation rate and that provides the best guide to medium-term inflation developments. In the current context, two factors make it especially difficult to interpret standard indicators of underlying inflation. First, the scale of the energy shock means that the producers of many goods and services that are included in the core inflation measure face higher energy input costs and are passing these cost increases on to consumer prices. To the extent that the increase in energy prices is a level effect, it follows that the knock-on impact on core prices is also primarily a level effect, rather than necessarily representing a shift in the persistent component of inflation. Second, the bottlenecks generated by the sectoral shifts in demand and supply associated with the pandemic are currently generating temporary inflation pressures, which also do not necessarily constitute a source of persistent inflation pressure.

Policymakers must strike the right balance in responding to shifts in projected inflation. In one direction, if forecasts indicate that the inflation target will be reached within the projection horizon, waiting for realised inflation to converge to the target before tightening might be excessively costly, especially if inflation expectations become de-anchored to the upside. Under this scenario, excessive delay in monetary tightening runs the risk of a sharper subsequent hike in interest rates and a greater loss in output.

In the other direction, if current inflation is above the target level but the forecasts indicate that inflation will fall below the target level over the projection horizon, tightening policy in response to temporarily-high inflation would be counterproductive. Under this scenario, premature monetary tightening runs the risk of an economic slowdown and a reversal in the medium-term inflation dynamic, de-railing the prospects of ultimate convergence to the inflation target. Of course, assessing these different types of policy errors is especially difficult in the current context of high uncertainty, the unique circumstances of the pandemic and policy settings that have long been driven by the twin challenges of excessively-low medium-term inflation pressures and the constraints associated with the effective lower bound.

An important element in the strategy review was to re-confirm the medium-term orientation of the ECB’s monetary policy. In line with the Treaty mandate and without prejudice to price stability, the medium-term orientation allows for inevitable short-term deviations of inflation from the target, as well as lags and uncertainty in the transmission of monetary policy to the economy and to inflation. It also provides room for monetary policy to take into account considerations such as balanced economic growth, full employment and financial stability. Under many scenarios, these are mutually consistent objectives. In particular, so long as longer-term inflation expectations are anchored at the target level, inflation will be at the target level if economic activity and employment are at their potential levels.

However, in the event of an adverse supply shock, the horizon over which inflation returns to the target level could be lengthened in order to avoid pronounced falls in economic activity and employment, which, if persistent, could jeopardise medium-term price stability. This consideration is relevant in developing the appropriate monetary policy response to the current energy shock and pandemic shock. In particular, it should be recognised that the prevalence of downward nominal rigidities in wages and prices means that surprises in relative price movements should mainly be accommodated by tolerating a temporary increase in the inflation rate, rather than by seeking to maintain a constant inflation rate that could only be achieved by a substantial reduction in overall demand and activity levels.

At the same time, it is essential to avoid that a spell of temporarily-high inflation pressures – even if arising from a supply shock – becomes entrenched by permanently altering longer-term inflation expectations. Accordingly, central banks must closely monitor the evolution of indicators of longer-term inflation expectations. From a policy perspective, the clearer is the commitment to the medium-term target of two per cent, the less likely is the de-anchoring of inflation expectations, since everyone should recognise that the central bank will take decisive action to ensure that deviations from the inflation target do not last too long and do not put at risk the stabilisation of inflation at two per cent over the medium term.

The new monetary policy strategy also contains a general commitment to base monetary policy decisions, including the evaluation of the proportionality of its decisions and potential side effects, on an integrated assessment of all relevant factors. Compared to the previous two-pillar analytical approach, there is an emphasis under the new integrated framework on taking into account the inherent macrofinancial links between the real economy, the monetary system and the financial system in terms of the underlying structures, shocks and adjustment processes. This framework reflects the importance of monitoring the transmission mechanism in calibrating monetary policy instruments and the recognition that financial stability is a precondition for price stability.

An important type of macro-financial risk in the euro area is that, under stressed conditions, self-fulfilling cross-border flight-to-safety episodes can impair the monetary policy transmission mechanism and threaten price stability. This is an inherent risk in a multi-country monetary union, since geographical portfolio shifts are facilitated by the absence of currency risk (compounded by the incomplete nature of the EMU architecture in relation to fiscal union and banking union) and can be reinforced by the lack of country-specific monetary policy instruments. Although monetary policy can be implemented in a uniform way most of the time, the ECB has demonstrated its capacity to design flexible instruments in reaction to stressed conditions through policy responses such as the Securities Market Programme (SMP), the Outright Monetary Transactions (OMT) programme and the pandemic emergency purchase programme (PEPP).

In recognition of the strategic importance of protecting the monetary policy transmission mechanism, the December 2021 monetary policy statement affirmed: "*Within our mandate, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardise the attainment of price stability.*" In addition to this general recognition of the value of flexibility under stressed conditions, the monetary policy statement also noted that, even after the end of net purchases under the PEPP at the end of March 2022, the accumulated PEPP portfolio can play a stabilising role: "*In particular, in the event of renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time*."

Conclusion

The 2021 strategy review lays the foundations for monetary policy decisions in the coming years. There is a clear anchor for monetary policy: we will set monetary policy to ensure that inflation stabilises at two per cent over the medium term. The medium-term orientation allows for inevitable short-term deviations of inflation from the target, as well as lags and uncertainty in the transmission of monetary policy to the economy and to inflation. The flexibility of the medium-term orientation takes into account that the appropriate monetary policy response to a deviation of inflation from the target is context-specific and depends on the origin, magnitude and persistence of the deviation.

In terms of policy instruments, there is a clear hierarchy. If the economy is not in the shadow of the effective lower bound and under non-stressed conditions, the set of policy interest rates is sufficient to deliver the inflation target. In particular, away from the effective lower bound, policy rates can be adjusted in either direction in response to upside or downside risks to the inflation target. However, in recognition of the effective lower bound on policy rates, the Governing Council can also employ forward guidance, asset purchases and longer-term refinancing operations, as appropriate. The Governing Council will continue to respond flexibly to new challenges as these arise and consider, as needed, new policy instruments in the pursuit of its price stability objective.

1. These remarks draw on Lane, P.R. (2022), "The Monetary Policy Strategy of the European Central Bank", Special Issue of *Revue d'Économie Financière*: New Doctrines in Central Banking,

forthcoming.

2. See Lane, P.R. (2022) “Bottlenecks and monetary policy”, The ECB Blog, 10 February and Lane, P.R. (2022) “Inflation in the near-term and the medium-term”, Remarks at the MNI Market News Webcast, 17 February.

3. In the current environment, short-term forecast errors have been sizeable, reversing the usual presumption that inflation uncertainty should be higher at longer horizons.

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