



EUROPEAN CENTRAL BANK

EUROSYSTEM

An overview of the ECB's monetary policy strategy

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1 Introduction

The new monetary policy strategy of the European Central Bank (ECB) was published on 8 July 2021. While the mandate is conferred upon the ECB by the Treaties, the ECB has to devise its monetary policy strategy. This strategy sets out how to achieve the primary objective of maintaining price stability in the euro area, referring to an appropriate set of monetary policy instruments, indicators and intermediate targets, as well as how to take into account other considerations without prejudice to price stability. 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; second, it serves as a vehicle for communicating with the public. The ECB's monetary policy strategy was last reviewed in 2003 and the changes that have since occurred to the economic and financial backdrop as well as to the predominant policy challenges warranted an update. This overview details the rationale and thinking behind the strategy and its main elements.

2 The economic backdrop and the past inflation narrative

The ECB's original monetary policy strategy, which was adopted in 1998 and reviewed in 2003, consisted of three main elements. First, it was based on a *double-key formulation of the price stability objective*, comprising a quantitative definition of price stability as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) of below two per cent, and, within that definition, the aim of maintaining inflation rates for the euro area "below, but close to, two per cent"; second, it had a *medium-term orientation* in view of the time lags in the effects of monetary policy on inflation; and third, the risks to price stability were analysed on the basis of *two pillars* – the economic analysis and the monetary analysis – with the information being cross-checked to form a unified overall judgement.

Since the ECB's previous monetary policy strategy review in 2003, the world has seen major changes that present central banks, including the ECB, with numerous new challenges. Of direct relevance for the conduct of monetary policy is the fact that structural developments have lowered the equilibrium real rate of interest – the interest rate consistent with inflation at its target and where the economy is operating at its potential – in the euro area (and globally).¹ There is broad consensus that a decline in productivity growth, demographic factors and persistently higher demand for safe and liquid assets in the wake of the global financial crisis have contributed to lowering the real equilibrium interest rate, although estimates remain subject to uncertainty. Combined with persistently low rates of inflation, the fall in the equilibrium real interest rate has increased the incidence and duration of episodes in which nominal policy interest rates are close to

¹ The equilibrium real interest rate is partly the result of policy choices. For example, the impact of demographics on the equilibrium real interest rate depends on policies such as the statutory retirement age and measures to boost the labour force participation rate.

the effective lower bound, with the current episode lasting longer than ten years. This situation provides a very different starting point compared with 2003, when the equilibrium real rate of interest was estimated to have been significantly higher than today.

The decline in the equilibrium real interest rate has reduced the space available for monetary easing by conventional interest rate policy in the face of disinflationary shocks. This reinforces the value of maintaining an inflation buffer over the medium term, so that the equilibrium nominal interest rate is sufficiently far above the effective lower bound to permit the active use of interest rate policy in response to adverse developments. In proximity to the effective lower bound, interest rate policy is unlikely to be sufficient to preserve price stability if disinflationary shocks occur, requiring the deployment of additional policy instruments (see also Section 3 for a detailed discussion of the implications).

In addition to the decline in the equilibrium real interest rate, the world has changed in other ways that have influenced the euro area economy and the environment in which monetary policy operates. The euro area has been hit by *several major shocks*, such as the global financial and sovereign debt crises, and more recently the coronavirus (COVID-19) pandemic, which have caused economic downturns and put downward pressure on inflation, thus necessitating substantial policy responses. *Globalisation and digitalisation* influence the structure of goods, services and labour markets and have a direct effect on prices that – when interacting with other factors, including constraints on monetary policy – may affect inflation beyond the short term. *Evolving financial structures*, such as the rise in financial intermediation via the non-bank sector, have altered the transmission of monetary policy. The *institutional architecture* of the euro area has also undergone substantial reform since 2003 but remains incomplete. *Climate change* – the greatest challenge facing humankind this century – and related mitigation policies alter the structure and dynamics of the economy and the financial system, thereby affecting price stability. The *communications* landscape has also changed, with today's landscape characterised by a declining reach of traditional (print) media; more fragmented, polarised and activist audiences; the rising importance of direct channels of communication such as social media; and increasing public demand for scrutiny and transparency.

A robust new strategy hinges on a thorough understanding of why inflation has been persistently low – and below the ECB's inflation aim – since 2013. The evidence indicates that a combination of interconnected factors is required to explain persistently low inflation. During the first decade of Economic and Monetary Union (EMU), shocks to inflation were predominantly upside shocks. Over the last decade, there has been a shift towards disinflationary shocks during and after the global financial crisis. *Cyclical drivers*, notably the disinflationary impact of the 2009 and 2012 twin recessions, have interacted with ongoing *structural trends* (such as globalisation, digitalisation and demographic factors) in a context in which the effective lower bound means that disinflationary shocks cannot easily be offset by interest rate policy. The persistence of low inflation has also contributed to lower

inflation expectations, which may have become less well anchored to the ECB's inflation aim.

The deployment of unconventional monetary policy measures, especially since 2014, has made a significant contribution to countering disinflationary pressures, dispelling deflation concerns and averting a more pronounced downward drift in inflation expectations. As part of the strategy review, an extensive assessment has been conducted of the ECB's set of unconventional monetary instruments, which found 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. The Governing Council assesses that these measures have been proportionate, taking into account potential side effects, for example on the financial sector and inequality. The proximity of interest rates to the effective lower bound and uncertainty about the effectiveness and side effects of other instruments have restricted the scale and speed of the monetary policy response to disinflationary shocks, contributing to the persistence of inflation rates below the inflation aim. 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. Finally, *fiscal policies*, on the back of debt sustainability concerns, were a drag on growth and inflation in the wake of the financial crisis.

3 The new ECB monetary policy strategy

3.1 The price stability objective

The strategy review takes the ECB's mandate as given. The Governing Council is bound by the ECB's primary mandate of price stability as enshrined in Article 127(1) of the Treaty on the Functioning of the European Union. Since the Treaty does not provide a precise definition of what is meant by maintaining price stability, it is the ECB's monetary policy strategy that defines how the Governing Council implements this mandate, including the choice of the price index, and how price stability is quantified. Such quantification provides a yardstick for the ECB's accountability and helps to achieve price stability by anchoring inflation expectations.

Measurement of the price index

The headline HICP remains the appropriate index for quantifying the price stability objective for the euro area and will be retained as the price index used to measure euro area inflation for monetary policy purposes. The assessment of the suitability of the HICP is based on four criteria: *timeliness*; *reliability* (e.g.

infrequent revisions); *comparability* (over time and across countries); and *credibility*.² Since 2003 the quality of the HICP as an inflation measure for the euro area has been significantly improved by Eurostat and the national statistical offices of the EU Member States. These improvements include the introduction of annual updates of expenditure weights, better representation of seasonal items and the provision of flash estimates for all Member States. While the price stability objective is quantified in terms of headline inflation, which is the broadest measure of the household consumption basket, the Governing Council will continue to monitor a wide set of price indicators, including measures of underlying inflation that exclude certain volatile components. Such measures have proven useful as signals of how inflation is likely to evolve over the medium-term horizon.

To further enhance the representativeness of the HICP and its cross-country comparability, the Governing Council has decided to recommend a roadmap to include owner-occupied housing (OOH) in the HICP. The Governing Council very much welcomes the European Statistical System's related work. Although costs related to shelter account for a large part of household expenditure, the HICP currently only partially includes the housing service costs of homeowners associated with owning, maintaining and living in their own home. In addition to practical measurement issues, it is also challenging to fully align these costs with the conceptual basis of the HICP.³ The ECB considers the net acquisition approach to be the preferred method for including OOH, based on the transaction prices that households pay for the acquisition of homes. Since the OOH price index measured with the net acquisition approach currently includes an element of investment, the ECB supports further research projects on optimal measurement methods. These should also aim at better isolating the consumption component from the investment component, with the former being the relevant one for monetary policy.

The roadmap foresees four main stages for moving to an HICP including OOH costs as the main index for monetary policy purposes. The first stage envisages the construction of an analytical index for internal purposes, which includes OOH with approximated weights. In parallel, the necessary legal work will be started and Eurostat intends to carry out further work on the statistical compilation of OOH weights, with a view to publishing in a second stage – likely in 2023 – an experimental quarterly HICP including OOH costs. In a third stage, likely to be completed by 2026, an official quarterly index will become available. In the fourth stage the aim would be to include OOH costs in the HICP at a monthly frequency and in a timely manner, which could pave the way for moving to an HICP including OOH costs as the main index for monetary policy purposes. At this point in time it is too early to provide a precise timetable for the fourth stage.

During the transition period the main reference index for monetary policy will remain the current HICP. This transition period will last until the OOH index has

² These criteria were also applied in the 2003 strategy review, see Issing, O. (ed.), *Background Studies for the ECB's Evaluation of its Monetary Policy Strategy*, ECB, 2003, p.12 ff.

³ The HICP only captures changes in the prices of goods and services which, when purchased, generate monetary transactions for consumption purposes. OOH generates monetary transactions only when dwellings are built and sold. Moreover, it is difficult to precisely identify whether a dwelling is purchased for consumption or investment purposes.

reached the timeliness and quality standards necessary for full integration into the monthly HICP index. Nevertheless, during the transition period the quarterly standalone OOH index will play an important supplementary role in assessing the impact of housing costs on inflation and will thus inform the Governing Council's monetary policy assessments.

A quantitative inflation target

Maintaining the ECB's primary objective of price stability can best be achieved by aiming for a specific quantitative target. While price stability can be viewed as a state in which changes in the general level of prices need not be factored into consumption and investment decisions, this general criterion requires a numerical definition to guide the conduct of monetary policy. At this juncture the Governing Council considers that price stability is best maintained by aiming for a two per cent inflation target over the medium term. The formulation of the price stability objective in terms of a specific quantitative target replaces the previous double-key formulation (which featured a definition of price stability in terms of inflation within a range from zero to two per cent and, within this definition, an inflation aim of below, but close to, two per cent). The new target is simple, clear and easy to communicate, and is thus expected to contribute to a more solid anchoring of longer-term inflation expectations.

Target level of two per cent

An inflation target of two per cent underlines the ECB's commitment to providing an adequate safety margin to guard against the risk of deflation and protect the effectiveness of monetary policy in responding to disinflationary shocks. This risk is more acute in the face of an *increased prevalence and duration of lower bound episodes* compared with the conditions prevailing in 2003, primarily owing to the fall in the equilibrium real interest rate. The level of the equilibrium real interest rate and the level of the inflation target jointly determine the available policy space in terms of nominal interest rates. All else being equal, a decline in the equilibrium real interest rate reduces the available policy space.

An inflation target of two per cent balances a range of considerations.

Simulation analysis shows that an inflation target of two per cent has good properties in terms of stabilising the average level of inflation over the long run at the target, keeping the variance of inflation contained and limiting the frequency of hitting the lower bound. At the same time, a two per cent target seeks to mitigate the welfare costs of higher inflation, which increase non-linearly with the level of the target. This explains the choice of a target level that is only slightly higher – at two per cent – than the inflation aim set in 2003. Moreover, this choice also reflects the fact that the ECB has adapted its monetary policy toolkit over time to partially overcome the constraints posed by the lower bound via the deployment of new monetary policy tools that have proven effective in lifting inflation (see Section 3.2).

Three additional factors, which were present already in 2003 and which have remained broadly unchanged since then, call for a sufficient inflation buffer.

First, an inflation buffer allows for a *smoother adjustment of macroeconomic imbalances across euro area countries*, avoiding inflation in individual countries persistently falling into negative territory. Second, by taking account of *downward nominal wage rigidities*, an inflation buffer reduces the risk of macroeconomic downturns being predominantly reflected in an excessive rise in unemployment. Third, such a buffer allows for the presence of *measurement bias* in the HICP, with a positive measurement bias implying that the “true” rate of inflation is lower than the measured level.

Symmetry of the inflation target

The new strategy implements the price stability objective in terms of an unambiguous and symmetric target. The previous double-key formulation of the price stability objective was successful in anchoring inflation expectations at levels consistent with the Governing Council’s definition of price stability at the time of the introduction of the euro, when the ECB had to establish its credibility in a context where the main concern related to inflation being too high. Later on, however, this double-key formulation may have led to possible ambiguity about the level of the inflation aim and a perception of the aim being asymmetric, which – in proximity to the effective lower bound – may have contributed to the low-inflation environment.

Symmetry in the inflation target means that the Governing Council considers negative and positive deviations of inflation from the target to be equally undesirable. The symmetric two per cent inflation target provides a clear anchor for longer-term inflation expectations, which is essential for maintaining price stability. Temporary and moderate fluctuations of actual inflation both above and below the medium-term target of two per cent are unavoidable; however, large, sustained deviations can destabilise longer-term inflation expectations. This holds for inflation that is too high as well as inflation that is too low. Accordingly, it is important for monetary policy to respond forcefully to large, sustained deviations of inflation from the target in either direction. The effective lower bound and the low equilibrium real interest rate – if persistent – mean that the risk of prolonged phases of below-target inflation outcomes is especially pronounced (the implications of this for the ECB’s policy response are discussed in Section 3.2). Anchoring the commitment to symmetry explicitly in the new strategic framework removes any remaining perception of ambiguity in the Governing Council’s aspirations. In particular, two per cent should not be interpreted as a ceiling.

The medium-term orientation

The new strategy confirms the medium-term orientation of monetary policy, which has served the Governing Council well in responding flexibly to economic shocks. The medium-term orientation is important to account for *uncertainties* in the inflation process and the transmission mechanism, so as to

recognise the imperfect control of inflation by monetary policy in the short run, owing to *variable transmission lags* to the economy and inflation. As different types of shock may move inflation and real economic activity in the same direction (as in the case of demand shocks) or create a temporary trade-off (as in the case of supply shocks), the medium-term orientation also provides the *policy flexibility* to assess the origin of shocks and look through temporary shocks that may dissipate of their own accord, thus *avoiding unnecessary volatility* in activity and employment.

A medium-term orientation allows the Governing Council to cater in its monetary policy decisions for other considerations relevant to the pursuit of price stability (see also Section 3.3). For example, 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 (as explained below).

Proportionality assessment as an integral part of monetary policy decisions

Each monetary policy decision by the Governing Council is based on an assessment of the monetary policy stance and the choice and design of instruments. The ECB's assessment of its *monetary policy stance* determines whether monetary policy is contributing to economic, financial and monetary developments in a way that maintains price stability over the medium term. The appropriate monetary policy stance is delivered via *the choice, design and calibration of instruments*, both individually and in combination.

In making monetary policy decisions, the Governing Council systematically assesses the proportionality of its measures. This assessment includes an analysis of the *benefits* and the possible *side effects* of monetary policy measures, their *interaction* and their *balance over time*. The assessment of the benefits applies to the transmission to financing conditions as well as to the intended effect on inflation, while the assessment of possible side effects relates to the unintended effects on the real economy and on the financial system. The proportionality assessment takes into account the uncertainty about the effectiveness and side effects of policy instruments, as well as the risks of a de-anchoring of longer-term inflation expectations from the two per cent target. The proportionality assessment is particularly important in the light of the use of monetary policy instruments other than the standard policy rates. The result of this assessment may affect both the intensity with which these measures are employed and their design, which can be calibrated to limit side effects (for example via the exclusion of household mortgages in the targeted longer-term refinancing operations) or to counteract undesirable side effects (such as through the introduction of a two-tier system for remunerating excess liquidity holdings).

3.2 Monetary policy implications of the effective lower bound

New monetary policy instruments in the ECB's toolkit

Since the equilibrium real interest rate will likely remain at low levels, it is prudent for monetary policy to factor in the effective lower bound constraint on nominal interest rates. Since the time of the 2003 review, the equilibrium real interest rate in the euro area has fallen significantly. Current market expectations suggest that the rate will remain low over the next decade. The ECB, like other major central banks, has had to find new ways beyond conventional interest rate policy to adjust the policy stance in order to counter the deflationary bias induced by the effective lower bound. Episodes characterised by policy rates in proximity to the effective lower bound can arise either from a low equilibrium real interest rate or from large and persistent disinflationary shocks that have driven down interest rates, or from a combination of the two factors. An additional complication specific to the euro area has been the fragmentation experienced following the sovereign debt crisis, which impaired the monetary policy transmission mechanism and – if left unaddressed – would have exacerbated downside risks to price stability.

The monetary policy instruments deployed by the ECB since the financial crisis have proven effective in countering disinflationary pressures and will remain an integral part of the ECB's toolkit in situations close to the effective lower bound. The primary monetary policy instrument is the set of ECB policy rates. Together with the extension of interest rate space into negative territory, the use of additional instruments such as forward guidance, asset purchases and longer-term refinancing operations will – as it has in the past – depend on the specific context and be calibrated with a view to reaching the ECB's inflation target in the medium term. Since the effective lower bound on interest rates is likely to continue to be an occasionally binding constraint in the future, these additional instruments will continue to play a role. They add to the policy space, although not unboundedly. At the same time, the Governing Council recognises the need to limit possible side effects of the new policy instruments and therefore remains committed to continuing to perform careful proportionality assessments and to adapting the design of measures related to these instruments with a view to minimising side effects, without compromising price stability.

Taking account of the asymmetry induced by the effective lower bound

The effective lower bound on nominal interest rates constrains the ability of conventional interest rate policy to offset disinflationary shocks. While central banks can, at least in principle, raise nominal interest rates without limits, there is only limited space to lower rates into negative territory, owing to the lower bound on cash and the possible existence of a state-contingent reversal rate at which interest rate cuts lose effectiveness. This limited ability to lower rates, if left unaddressed, will

result in persistent downward deviations of inflation from the target, in particular when the economy is repeatedly hit by disinflationary shocks. This could lead inflation expectations to settle below the central bank's target rate, and this risk is especially high if the inflation target is perceived to be a ceiling. Forward guidance, longer-term refinancing operations, negative interest rates and asset purchases have helped to partially overcome the constraints induced by the lower bound and will continue to be used as appropriate. The Governing Council will continue to respond flexibly to new challenges as they arise and consider new policy instruments, if proportionate and as needed, in the pursuit of its inflation target.

The commitment to a symmetric inflation target requires especially forceful or persistent monetary policy action when the economy is close to the effective lower bound, to avoid negative deviations from the inflation target becoming entrenched. An especially forceful or persistent response to negative deviations is warranted by the need to support the anchoring of longer-term inflation expectations at two per cent, which helps to maintain price stability over the medium term. 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. This may also imply a transitory period in which inflation is moderately above target.

The stabilising role of fiscal and other policies

Fiscal and other policies are important for macroeconomic stabilisation, especially in the proximity of the effective lower bound. Countercyclical fiscal policy requires determined action during large recessions, but it also crucially requires the rebuilding of buffers once the economy is firmly back on track, so as to ensure debt sustainability. By stabilising the economy in large recessions, while ensuring debt sustainability, fiscal policy also makes its best contribution to price stability. By contributing to macroeconomic stabilisation, countercyclical fiscal policy amplifies the effectiveness of monetary policy. While in normal times the stabilisation role of fiscal policy can be largely confined to the operation of automatic stabilisers, countercyclical discretionary fiscal policy is important in times of crisis and especially in proximity to the lower bound. First, the experience gained in the 2008-09 global financial crisis, the 2011-12 euro area crisis and the 2020-21 global pandemic suggests that effective macroeconomic stabilisation requires fiscal policy and monetary policy to complement each other in times of crisis. Second, there is ample empirical evidence suggesting that an expansionary fiscal policy is particularly effective when interest rates are near the lower bound. Moreover, fiscal and structural policies can support productivity and labour supply growth, helping to reverse the trend in the equilibrium real interest rate and thereby create monetary policy space. Finally, completing EMU, including banking union and capital markets union, is essential to strengthen the euro area's shock absorption capacity.

3.3 Other considerations relevant to the pursuit of price stability

Without prejudice to price stability, in its monetary policy decisions the Governing Council caters for other considerations relevant to the conduct of monetary policy. Taking such considerations into account will often be necessary to maintain price stability over the medium term. At the same time, monetary policy measures have an impact on the economy and on economic policies. The Treaty specifically requires the Eurosystem to support the general economic policies in the European Union with a view to contributing to the achievement of the Union's objectives as laid down in Article 3 of the Treaty on European Union. These objectives include 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 – without prejudice to the objective of price stability. The Eurosystem shall also contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system. Finally, the Eurosystem shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

When taking these considerations into account, the Governing Council bases its assessment in particular on the relevance of these considerations for the ECB's primary objective and the ECB's ability to support the general economic policies in the Union, with a view to making a contribution to the attainment of the Union's objectives. For example, when adjusting its monetary policy instruments, the Governing Council will – provided that two configurations of the instrument set are equally conducive and not prejudicial to price stability – choose the configuration that best supports the general economic policies of the Union related to growth, employment and social inclusion, and that protects financial stability and helps to mitigate the impact of climate change, with a view to contributing to the objectives of the Union.

The complementarity of price stability with balanced economic growth and full employment

To a large extent, balanced economic growth, full employment and price stability are mutually consistent objectives. If longer-term inflation expectations are anchored, inflation will be at the target level if economic activity and employment are equal to their potential levels. The medium-term orientation of the ECB's monetary policy strategy takes account of situations in which inflation on the one side and economic activity and employment on the other side temporarily move in different directions owing to supply-side disturbances. For example, in the presence of an adverse supply shock, the Governing Council may decide to lengthen the horizon over which inflation returns to the target level in order to avoid pronounced falls in economic activity and employment, which, if persistent, could themselves jeopardise medium-term price stability. One practical difficulty is the unobservability of potential output and equilibrium employment, against which to assess current activity and employment. On this basis, in 2003 the ECB did not commit to any

particular estimate of potential output or of the natural rate of unemployment; likewise, in the current review the Governing Council deemed it important to look at a variety of estimates and to account for uncertainty, heterogeneity and ongoing structural changes shaping the outlook for economic activity and employment in the euro area and its member countries. The Governing Council will also continue to assess the two-way interaction between income and wealth distributions and monetary policy.

Taking account of financial stability considerations

Financial stability is a precondition for price stability and vice versa. Under stressed financial market conditions, monetary policy measures aimed at maintaining price stability typically help to restore financial stability by addressing impairments to the monetary policy transmission mechanism and averting negative macro-financial feedback effects and debt-deflation phenomena. In relation to the build-up of financial stability risks, macroprudential and microprudential policies are the first line of defence. In many instances, macroprudential policies and monetary policy are complementary. For instance, macroprudential policies that avoid a build-up of imbalances reduce the likelihood of future financial crises with negative effects on price stability. Monetary policy may also affect financial stability risks. In one direction, accommodative monetary policy can reduce credit risk by boosting activity levels and inflation dynamics; in the other direction, accommodative monetary policy may encourage the build-up of leverage or raise the sensitivity of asset prices. Symmetric arguments apply during phases of monetary policy tightening.

In view of the price stability risks generated by financial crises, there is a clear conceptual case for the ECB to take financial stability considerations into account in its monetary policy deliberations. This reflects existing limitations of macroprudential policy in the different phases of the financial cycle, the interactions between macroprudential policy and monetary policy, and possible side effects of monetary policy on financial stability. At the same time, it is important to avoid the misperception that monetary policy is responsible for guaranteeing financial stability. The Governing Council does not conduct systematic policies of either “leaning against the wind” (whereby monetary policy is systematically tightened when systemic risk builds up) or of “cleaning” (whereby monetary policy is systematically loosened when systemic risk materialises). Rather, it follows a flexible approach in taking account of financial stability considerations. Any monetary policy reaction to financial stability concerns will depend on prevailing circumstances and will be guided by the implications for medium-term price stability. To this end, the preparation of monetary policy deliberations will be enhanced with additional information on financial stability considerations, in the context of overhauling the ECB’s analytical framework (see Section 4).

Taking account of the impact of climate change

The Governing Council is committed – within the ECB’s mandate – to ensuring that the Eurosystem fully takes into account the implications of climate change and the carbon transition for monetary policy and central banking.

Addressing climate change and the carbon transition is a major global challenge and a policy priority for the European Union. While governments have the primary responsibility and tools for addressing climate change, the ECB’s mandate requires the ECB to assess the impact of climate change and to further incorporate climate considerations into its policy framework, since 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. For any action, it always has to be analysed to what extent it conditions the Governing Council’s ability to maintain price stability.

The Governing Council has committed to an ambitious climate-related action plan to further include climate change considerations in its monetary policy framework (see the press release).

The action plan outlines the key areas of ongoing and planned actions by the ECB to more systematically reflect climate change considerations in its monetary policy operations. First, the ECB will significantly enhance its analytical and macroeconomic modelling capacities and develop statistical indicators to foster the understanding of the macroeconomic impact of climate change and carbon transition policies. Second, the Governing Council will adapt the design of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework.

4 The ECB’s integrated analytical framework

The pervasive structural changes that the global and euro area economies and financial systems have undergone since 2003 have entailed continuous updating of the ECB’s analytical tools and framework.

The structural changes outlined in Section 2 have had consequences for the growth potential of the euro area economy, the equilibrium real interest rate, the inflation process and the transmission of monetary policy. This has required the ECB to integrate these trends into its regular assessment and the policy preparation process. In view of these changes, the economic and monetary analyses have evolved in several ways that should be reflected formally within the ECB’s analytical framework. Changes to the economic analysis reflect the availability of new data and information sources, as well as modelling and computational developments, the important role of the Eurosystem and ECB staff macroeconomic projections in forming a view on the medium-term outlook for economic activity and inflation, and also the more systematic analysis of (changes to) structural trends. The monetary analysis has shifted from its main role of detecting risks to price stability over medium to longer-term horizons towards a stronger emphasis on providing information for assessing monetary policy transmission. This shift in focus reflects a weakening of the empirical link between monetary aggregates and inflation, impairments in monetary

policy transmission during the global financial crisis and the broadening of the ECB's monetary policy toolkit.

Given these changes, the ECB's monetary policy deliberations will be based on a revised integrated analytical framework that brings together two analyses: the economic analysis and the monetary and financial analysis. The integrated framework takes account of the inherent links between the underlying structures, shocks and adjustment processes covered by the respective analyses. Both analyses provide valuable information and thus together they contribute to a comprehensive and robust assessment of the outlook for and the risks to price stability over different time horizons. The new framework will replace the previous two-pillar framework and discontinue the cross-checking of the information derived from the monetary analysis with the information from the economic analysis. To underpin the integrated analysis, further investment in developing the analytical tools will be required to model and understand the macro-financial linkages and the interactions between monetary policy measures, their transmission to the economy and their effects on the stability of the financial system.

The economic analysis focuses on real and nominal economic developments. It is built around the analysis of *developments in the short term* in economic growth, employment and inflation, the assessment of the *drivers of shocks* that hit the euro area economy, the *Eurosystem and ECB staff projections* of key macroeconomic variables over a medium-term horizon, and a broad-ranging *evaluation of the risks* to economic growth and price stability. Due emphasis will be given to the regular *analysis of structural trends* and their implications for inflation, potential output and the equilibrium real rate of interest; the role and importance of *heterogeneities* and of *non-linearities*; and the use of newly available granular data, including *surveys of expectations*, such as the newly established Consumer Expectations Survey.

The monetary and financial analysis has significantly shifted in focus since the 2003 review in response to the challenges that arose during and after the global financial crisis. The monetary and financial analysis assigns an important role to examining monetary and financial indicators, with a focus on the operation of the *monetary policy transmission mechanism*, in particular via the credit, bank lending, risk-taking and asset pricing channels. Such assessments facilitate the identification of possible changes in transmission (for example related to structural factors such as the rise in non-bank financial intermediation) or impairments in transmission, for example owing to fragmentation or market stress. The monetary and financial analysis also provides for a more systematic evaluation of the *longer-term build-up of financial vulnerabilities and imbalances* and their possible implications for the tail risks to output and inflation. Moreover, it assesses the extent to which *macroprudential measures mitigate possible financial stability risks* that are relevant from a monetary policy perspective. The monetary and financial analysis thus recognises that financial stability is a precondition for price stability.

The integrated analytical framework will continue to consider the information from monetary and credit aggregates. Such aggregates, together with other variables that are used to assess the functioning of the monetary and financial transmission, will continue to be fully included in the new framework, reflecting their

ongoing relevance for the assessment of the build-up of vulnerabilities in and risks to price stability. Moreover, an in-depth assessment of the interaction between monetary policy and financial stability will be conducted as part of the monetary and financial analysis at regular intervals and considered at the monetary policy meetings of the Governing Council, drawing on the Financial Stability Review and other relevant material.

5 The communication of the ECB's monetary policy decisions

The importance of monetary policy communication has increased significantly over time. Monetary policy communication has become a monetary policy tool in itself, with forward guidance being a prominent example. The better monetary policy is understood, not only by experts but also by the general public, the more effective it will be. Communication also plays a key role in ensuring that the ECB as an independent central bank fulfils its duty of accountability towards the public and retains credibility and legitimacy. Consistent, clear and effective communication with different audiences is therefore essential, and the Governing Council is committed to explaining its monetary policy strategy and decisions as clearly as possible to all audiences.

The Governing Council thoroughly reviewed the sequential communication of its monetary policy decisions, with a view to enhancing the information provided and its accessibility for various audiences. Communication of monetary policy decisions will continue to build on four products that have proven their value: the press release, the introductory statement, which will be renamed the “monetary policy statement”, the Economic Bulletin and the monetary policy account. The monetary policy statement will be streamlined and its clarity improved. Its structure will be adapted, with a focus on an integrated narrative, in line with the new analytical framework outlined in Section 4. The statement will no longer refer to the notion of cross-checking between pillars, but will set out a narrative motivating the policy decision that draws on information from the economic, monetary and financial analysis. The monetary policy accounts, which were introduced in 2015, will continue to provide information on the full range of arguments considered during the Governing Council's monetary policy deliberations. The Economic Bulletin will continue to provide an overview of the economic situation and analysis of topical issues of relevance to monetary policy. It will be enhanced with more analysis of monetary and financial issues and will provide a regular update on the ECB's proportionality assessments, while further efforts will be made to make it more readable and engaging. These products will be complemented by a layered and more visual version of policy communication geared towards the wider public.

The ECB's strategy review has benefited enormously from the input received via the Eurosystem's “listening” activities. During the review period the Eurosystem held numerous events with the academic community, civil society organisations and the public at large, and it also held exchanges with national

parliaments and the European Parliament.⁴ In addition, the ECB received approximately 4,000 responses to a set of questions via its “ECB Listens Portal”. All this input fed into the Governing Council deliberations in the context of the strategy review. Some of the main messages highlighted include the negative effect of inflation on people’s daily lives; the significant effect of the cost of housing on people’s perceived levels of inflation, with many respondents arguing for the inflation measure to better account for housing costs; concerns about the side effects of the ECB’s policies; calls on the ECB to promote economic growth and employment and to help protect the environment, without overstepping its mandate; and the view that central banks need to explain their role better and use understandable language and relatable examples to engage with the wider public. The Governing Council intends to make outreach events a structural feature of the Eurosystem’s interaction with the public. Such future events will have both a “listening” and an “explaining” dimension, to enable the public to understand the ECB’s monetary policy strategy and its implications.

6 A regular review cycle

In a rapidly changing world, the ECB’s monetary policy strategy will likely need to be reviewed and adapted more regularly. While such changes are difficult to predict, some areas where developments are foreseeable in the coming years that could alter the economic and financial landscape in which monetary policy operates include possible advances in terms of a digital currency; improvements in the EMU architecture; the ongoing structural changes in the euro area financial system, including the increasing role of non-banks; further major economic or financial shocks to the euro area and/or global economies; and additional structural changes that affect the inflation process, the equilibrium real interest rate or the growth potential. Against this background, the Governing Council intends to assess periodically the appropriateness of its monetary policy strategy, with the next assessment expected in 2025.

⁴ See the [summary report on the ECB Listens event](#) and the [overview of events held by national central banks](#).

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For specific terminology please refer to the [ECB glossary](#) (available in English only).