ECONOMIC RESEARCH

ECB Strategy Review

Easy does it!

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Katharina Utermöhl, CFA
Senior Economist Europe
Allianz Research
Katharina.utermoehl@allianz.com

There is magic in every beginning…

Today's ECB meeting was uneventful when it comes to the short-term monetary policy outlook as all policy rates remained unchanged (with the deposit rate at -0.5%) and the pace of monthly QE purchases was confirmed at EUR 20bn. However in terms of the medium to long-term monetary policy direction, the January 2020 policy meeting proved noteworthy with President Christine Lagarde officially sounding the starting shot to the ECB's first strategy review in two decades. Despite expectations regarding the potential impact of the exercise running high, we think that the strategy review will not bring about a dramatic overhaul of the ECB's monetary policy framework.

…but the strategy review will be no walk in the park

Clearly after 17 years a review of the ECB's strategy is long overdue. But make no mistake, it will neither prove to be a walk in the park nor will it magically solve the ECB's problems. After all since 2003 the issues facing central banks around the globe have multiplied and become far more complex. This is perhaps particularly true for the ECB since the eurozone economy has undergone profound changes over the last few years. Moreover the strategy review, which is expected to conclude by the end of 2020, will hardly brush aside the differences within the ECB governing council which to a large extent are not about subtle disagreement in style but instead concern fundamental differences about what central banks should and should not do. With President Lagarde expected to pursue a more collaborative leadership style we think that she will not impose any strategic changes in the absence of a clear majority. As a result instead of a complete overhaul, the changes to the monetary policy framework will probably be more subtle - and that is good news in our view.

Review will go beyond the ECB's bread & butter business

The main focus of the review will clearly be on the monetary policy framework. However this is not simply about setting a new inflation target. Above all the review should be understood as an opportunity for the ECB to deepen its understanding of the inflation process and, more precisely, why inflation has stayed so low for so long in spite of the ECB's ultra-expansive monetary policy stance. The average annual inflation rate for the period 2009-2019 has registered at 1.3% - notably below the current target of below, but close to, 2%. The outcome of this exercise should then help guide any adjustments in the key elements underpinning the ECB's monetary policy framework including the definition of the inflation target consistent with price stability, the identification of an appropriate inflation gauge and the relevant tools to steer inflation in the desired direction. Beyond the bare monetary policy basics, the strategy review will also dive into non-core policy issues such as the ECB's communication practices and the transparency of its monetary policy decision-making process as well as how other considerations, such as financial stability, employment and environmental sustainability, can be relevant in pursuing the ECB's mandate.

Beware of a hasty strategy overhaul and opt for more flexibility instead!

We think the ECB should refrain from a substantial overhaul of its strategy but rather stick to cautiously tweaking its monetary policy framework with a view on introducing more flexibility. In a context of subdued energy prices and structural drivers behind low inflation such as globalization and technological change, there are mounting doubts over the ability of central banks to precisely steer inflation towards a point target. Along that logic the current inflation gauge as well as the 2% inflation target should be maintained. Clearly 2% is also a compromise target. After all a higher inflation target would be inappropriate for some members on the basis that the ECB has struggled to even reach the 2% goals and that it would stretch the interpretation of "price stability", whereas a lower target would have some members concerned that as a result interest rates could stabilize at too low a level to provide a buffer against future economic downturns. However in an effort to clarify the policy target and introduce more flexibility, the target should be made symmetric with a band around the goal that allows for a +/- 1ppt deviation without triggering a policy reaction. Meanwhile the current inflation gauge should be adjusted to focus more on underlying inflation trends and to incorporate the cost of housing or at least should be complemented by additional inflation measures.

As regards its communication strategy the ECB should follow the lead of the Bank of England and opt to release detailed minutes as well as take regular votes and publish the records. More openness about individual views of policy-makers would enhance monetary policy transparency and in turn also its effectiveness. In addition, providing a voice to dissenting members should help strengthen the unity of the governing council by signaling that it is able to accommodate differing views.

Regarding how to incorporate climate change consideration in its strategy, a topic that President Lagarde has called "mission critical" the ECB should steer away from greening its monetary policy tools (i.e. "green QE") and instead focus on safeguarding financial stability. This could include incorporating financial stability and economic risks - stemming for instance from stranded assets and failed attempts to tackle climate change effectively - in its analytical models and forecasts and taking climate change risks into account when valuing collateral of banks. Eventually this could also extend to checking that banks are taking account of these risks in their risk management as part of the European banking stress test. However beyond that in the fight against climate change it should be democratically elected governments and not central banks that sit in the driving seat for instance by adjusting regulation, taxes, subsidies and public investment etc. This is particularly true given the potential negative side effects from a green monetary policy which range from loss of credibility and independence to fueling green asset bubbles.

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