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The new monetary policy strategy of the European Central Bank*

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*English translation of the original in Spanish

The Governing Council of the European Central Bank (ECB) adopted a new monetary policy strategy on 7 July which will determine the way in which the ECB conducts its monetary policy in the coming years and will have a decisive influence on the economy of the euro area. It is therefore worth explaining the rationale and main pillars of this new strategy to the general public.

The Maastricht Treaty, which paved the way for the Economic and Monetary Union, conferred a primary mandate on the ECB: that of ensuring price stability in the euro area as a whole, as a precondition for macroeconomic stability and, consequently, for social well-being.

The ECB had to independently adopt a precise definition of this objective and decide how to attain it. In 1998, it defined price stability as a year-on-year increase of below 2% in the Harmonised Index of Consumer Prices (HICP) for the euro area. In 2003, the institution clarified that the objective was to keep inflation rates below, but close to, 2% over the medium term. As its main instruments, the ECB would use its policy rates on the lending and deposit facility it offers banks. These rates pass through to the financing conditions of public and private agents and to financial and real asset prices, and they ultimately have an impact on economic activity and inflation.

The changes that the European economy has undergone since 2003 and the new challenges ahead have warranted an update of the strategy. From the ECB's standpoint, the most significant change has been the gradual decline in the so-called equilibrium interest rates, i.e., those that allow economy activity to continue operating at its potential level and keep inflation at its target. This decline can be explained by factors such as lower productivity growth, progressive population ageing and the legacy of the global financial crisis.

Against this backdrop, in order to fulfil its price stability mandate, the ECB has in recent years cut its policy rates to historically low levels, with some of its main benchmarks even falling into negative territory. Such is the case of the remuneration received by banks for depositing their liquidity with the ECB, which currently stands at -0.5%. That said, euro area inflation has remained significantly below 2% since 2014, except on isolated occasions. Indeed, a setting in which inflation is below target, along with the existence of a lower bound on interest rates, has led the ECB and other central banks to implement new monetary policy instruments, such as financial asset purchases, to provide greater monetary stimulus.

Why is there a lower bound on interest rates? Interest rates cannot fall unlimitedly without causing frictions in the normal functioning of the financial system, and this could ultimately reduce the effectiveness of monetary policy. This is what is known as the problem of the "lower bound on interest rates". If this constraint on the central bank's ability to act persists over time, it may eventually lead to a downward bias both in actual inflation and in agents' expectations of future inflation developments, hindering the central bank's task of achieving price stability.

This was a well-known problem in 2003, but it was considered of scant practical significance and unlikely to put constraints on the ECB's actions. However, past experience has shown that this lower bound, along with the aforementioned fall in the equilibrium interest rates, are the main challenges facing the ECB's monetary policy. To address this problem, our new monetary policy strategy includes two key new elements.

First, it sets a new inflation target of 2% over the medium term, which is slightly higher than the previous target. The strategy also underlines that this target is symmetric, meaning that negative and positive deviations from the target are equally undesirable. Thus, the new definition removes the perceived ambiguity and asymmetry of the previous inflation target (which was "below, but close to, 2%"). In recent years, this asymmetry has, in fact, appeared to have contributed to the persistence of low inflation in the euro area, since it has not succeeded in anchoring inflation expectations at the set target level. In short, under the new strategic framework, 2% is not a "ceiling", but the medium-term inflation target.

Second, and perhaps more important for addressing the problem of the lower bound, our new strategy explicitly recognises that the commitment to attain symmetric 2% inflation requires especially forceful or persistent monetary policy action when interest rates are close to their lower bound, to avoid negative deviations from the inflation target becoming entrenched. A significant aspect that is specifically mentioned in the new strategic framework is that this type of monetary policy response may imply transitional periods in which inflation stands moderately above target.

The primary monetary policy instrument will continue to be the set of ECB policy rates. However, if appropriate, we will also make use of the monetary policy toolkit introduced in recent years, particularly forward guidance, financial asset purchases and longer-term refinancing operations. Moreover, we will consider deploying new instruments, if necessary, to achieve the price stability objective.

In relation to the measurement of inflation, the HICP remains the appropriate price index for assessing achievement of the price stability objective. However, it is recognised that the inclusion, if technically possible, of the costs related to owner-occupied housing would better represent the inflation relevant for households. To this end, the value of the housing as a real asset will have to be isolated from the value to its owner as an asset that also provides a housing service, which is the relevant component for monetary policy.

Further, we have announced our commitment to ensure that the Eurosystem takes into account the implications of climate change for monetary policy and central banking through an action plan that includes climate-related factors in its assessment of monetary policy and adapts its operational framework accordingly.

To sum up, all of us on the ECB Governing Council hope that these changes to our strategy will improve our ability to fulfil the mandate that the founding treaties conferred on this institution and that is so important for delivering economic prosperity and promoting well-being for European citizens.