BANCO DE ESPAÑA
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THE ECB'S NEW MONETARY POLICY STRATEGY

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THE PREVIOUS MONETARY POLICY STRATEGY

- The Treaty on European Union designated **price stability** as the ECB's primary mandate, leaving it to the ECB to define exactly what price stability should be and how it should be achieved

- In 1998, the ECB defined price stability as a **year-on-year increase in the HICP of below 2%**

- In 2003, the ECB clarified that, in the pursuit of price stability, a target was set for **inflation rates to be below, but close to, 2%** over the medium term

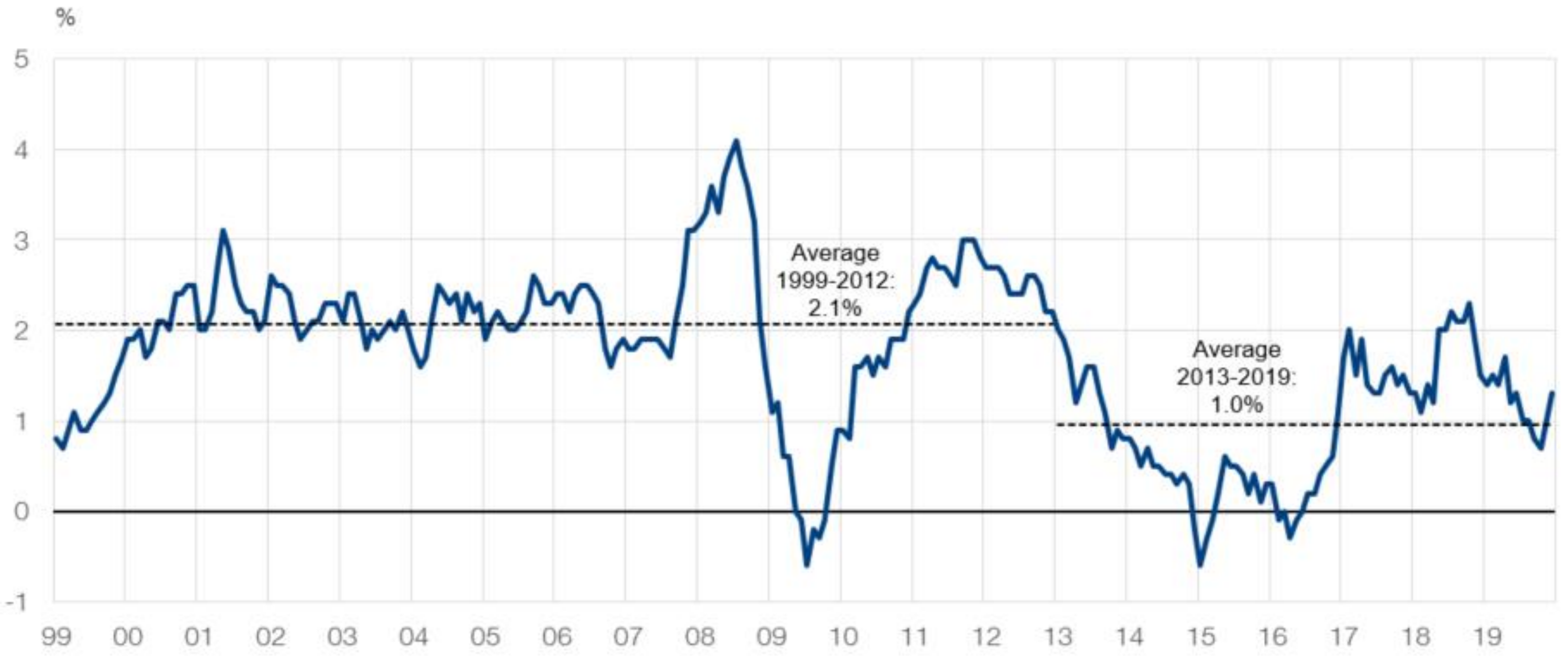
- To achieve this, its primary **instruments** were its **policy interest rates** (deposit facility, main refinancing operations, marginal lending facility)

- During the first decade of the euro, against a backdrop of mainly inflationary shocks, inflation hovered around target levels

Source: Eurostat.

- However, with the onset of the global financial crisis in 2008, a second phase began marked by **disinflationary shocks**…
- … and characterised by **interest rates close to their lower bound** and, from 2013 onwards, by **inflation persistently below target**

EURO AREA HICP (1999-2019)



Source: Eurostat.

- Against this background, and in view of the structural changes in the euro area economy over the previous two decades, it became clear that **the strategy needed to be revised**

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THE STRATEGY REVIEW WAS PROMPTED BY STRUCTURAL CHANGES IN THE EURO AREA OVER THE PAST FEW DECADES

- The main structural change that has prompted the review is the **fall in the euro area's equilibrium real interest rate** in recent decades
  - The **equilibrium real interest rate (*r**)** is the real interest rate level that allows activity to stabilise at potential output and inflation at its target
  - To achieve stable inflation, the central bank tries to keep the real interest rate at the natural rate level
- This fall reflects lower productivity growth, adverse demographic factors and the aftermath of the global financial crisis, among other factors
- The fall in r^* means that the **lower bound on interest rates** increasingly constrains the ECB's ability to achieve its objectives through the use of policy interest rates
- In the previous strategy review (2003) this limitation was taken into account, but it was considered unlikely that it could constrain monetary policy in the future

THE ESTIMATED FALL IN THE EQUILIBRIUM REAL INTEREST RATE

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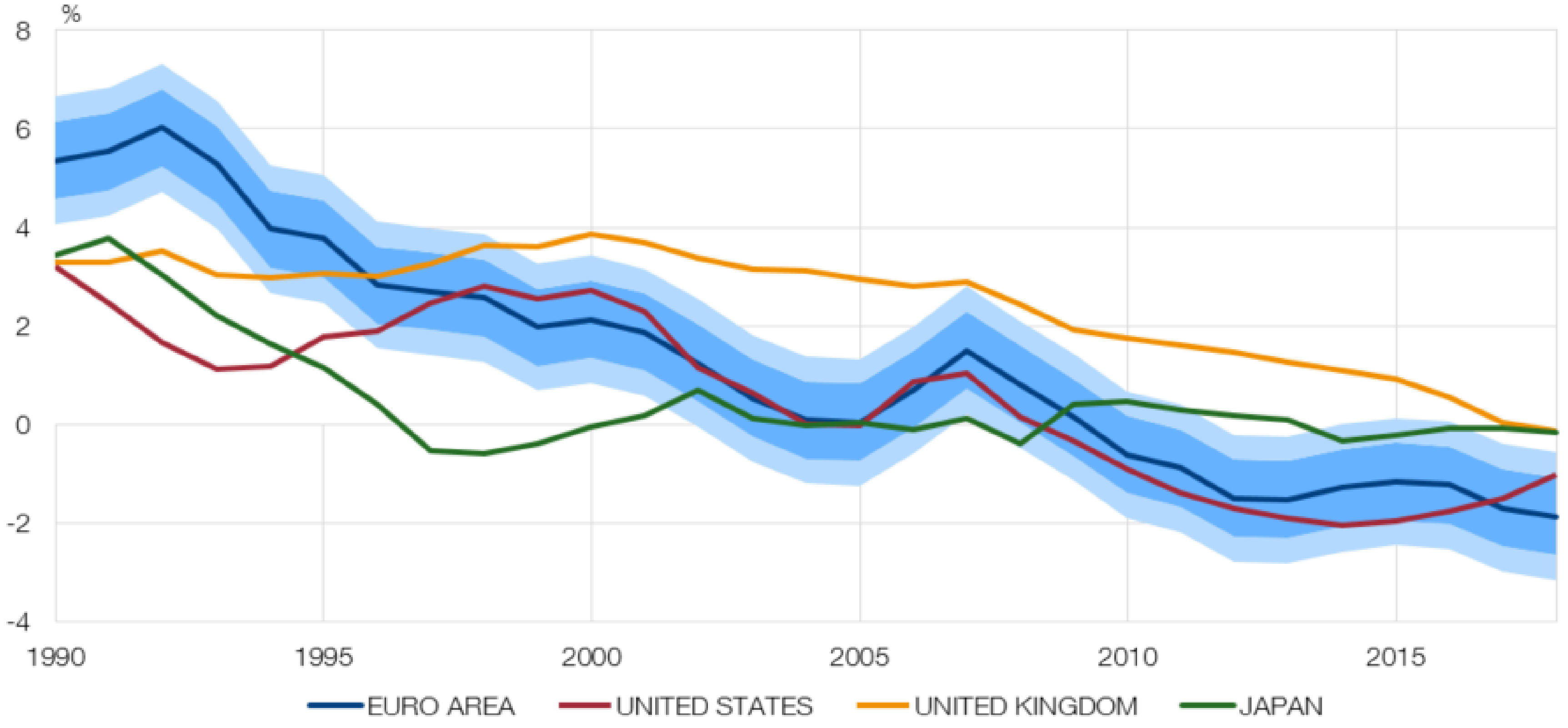
CHANGE IN NATURAL RATE OF INTEREST IN MAIN ADVANCED ECONOMIES

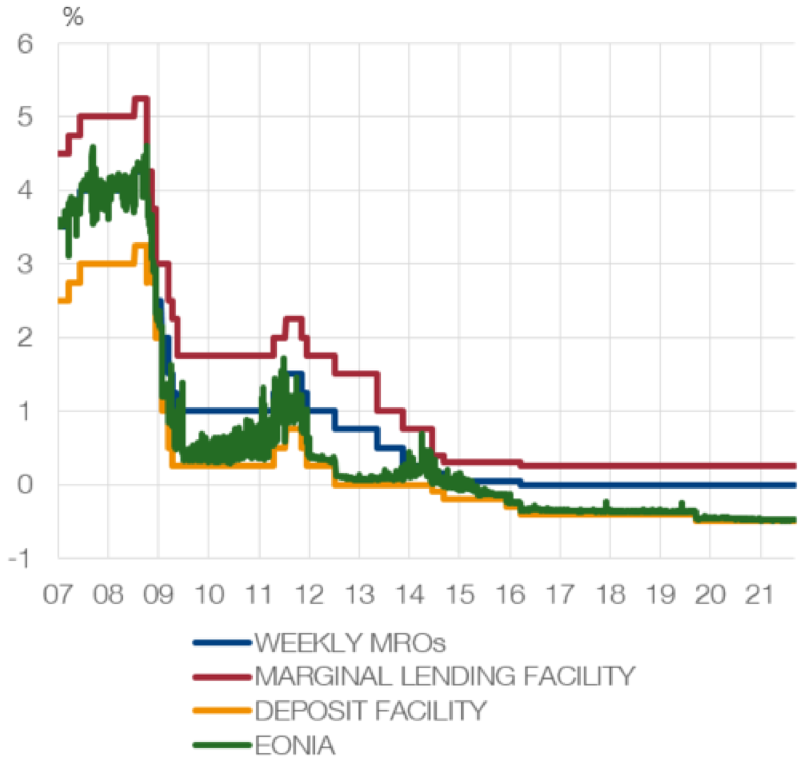


Source: 2018 Annual Report, Banco de España, drawing on the model of Fiorentini, Galesi, Pérez-Quirós and Sentana (2018).
The euro area bands denote 68% and 90% confidence levels.

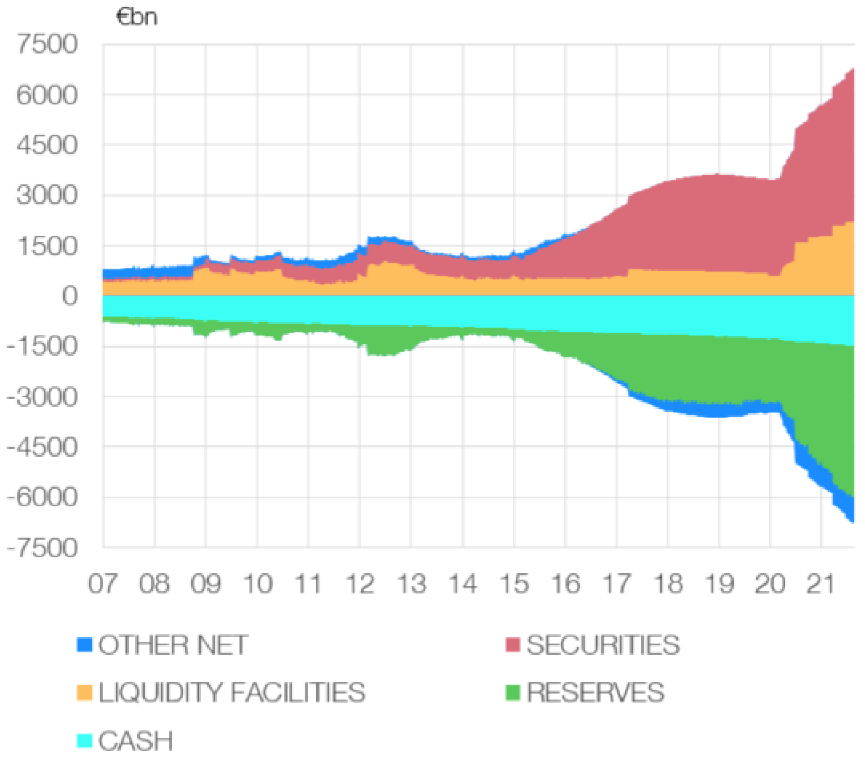
THE PROXIMITY OF INTEREST RATES TO THEIR LOWER BOUND LED THE ECB TO RESORT TO NON-STANDARD MEASURES…

- Measures such as the asset purchase programmes (APP), longer-term refinancing operations ((T)LTROs) and forward guidance sought to add monetary stimulus, in the face of the relatively little room to implement additional interest rate cuts

1 ECB POLICY RATES AND EONIA



2 EUROSYSTEM BALANCE SHEET

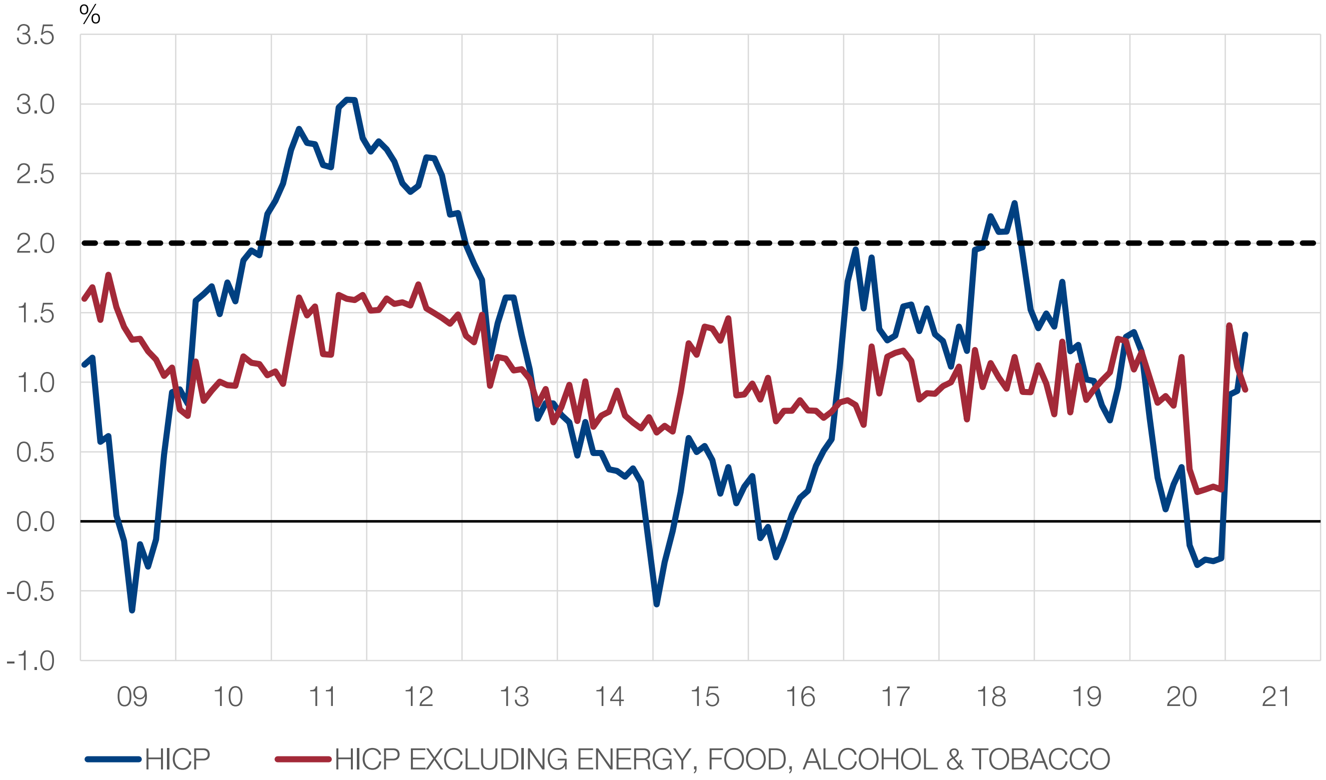


Sources: Thomson Reuters Datastream and ECB.

… DESPITE WHICH EURO AREA INFLATION REMAINED PERSISTENTLY BELOW ITS (PREVIOUS) TARGET

- Before the pandemic, general inflation in the euro area had already been fluctuating around off-target levels (the target being "below, but close to, 2%")
- **Core inflation** had stabilised around levels well below 2%, making it even more difficult for headline inflation to converge to the target

HEADLINE AND CORE EURO AREA INFLATION



SOURCE: Eurostat. Last observation: March 2021.

THE DEFINITION OF THE INFLATION TARGET ITSELF ALSO PRESENTED PROBLEMS

- The previous inflation target ("<u>below</u>, but close, to 2%") risked being interpreted as **asymmetric**, i.e. that the monetary policy response to deviations of inflation was more forceful when they were **above** target than below target

- This perceived asymmetry was not conducive to anchoring inflation expectations at levels truly close to 2%.

- Moreover, the numerical inflation target itself was not well defined ("close to": 1.7%? 1.8%? 1.9%?)

- There was therefore a case for redefining the inflation target, rendering it **clearer and more symmetric, and thus preventing it from being interpreted mechanically as an inflation "ceiling"**

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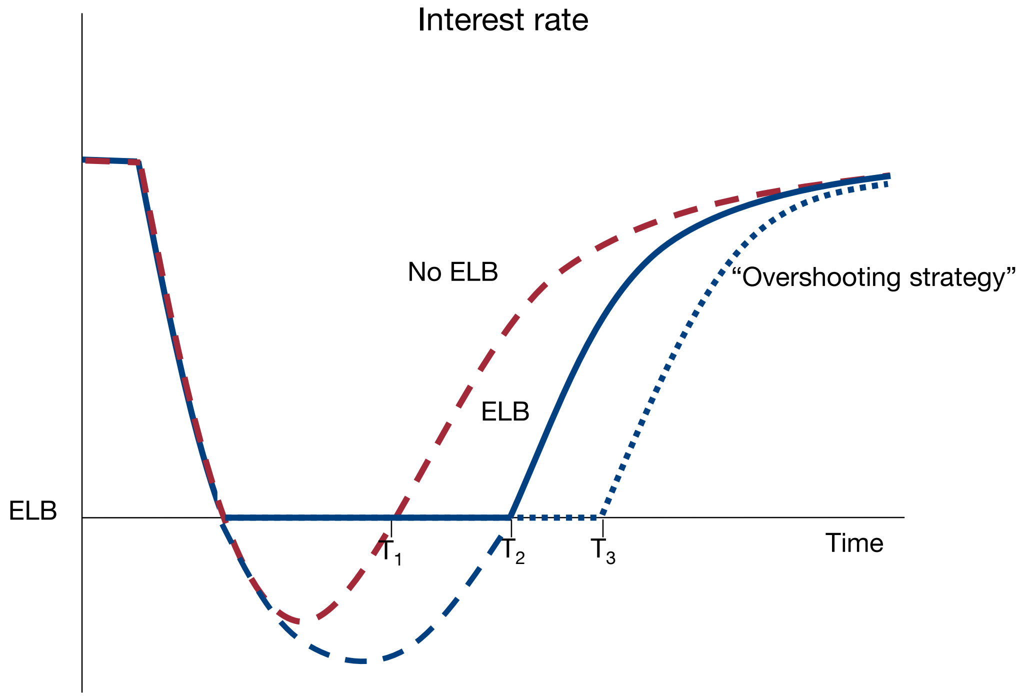
- To make the inflation target clearer and more symmetric, and address the difficulties arising from lower equilibrium real interest rates and the lower bound on nominal rates, the new strategy includes **two essential changes**:

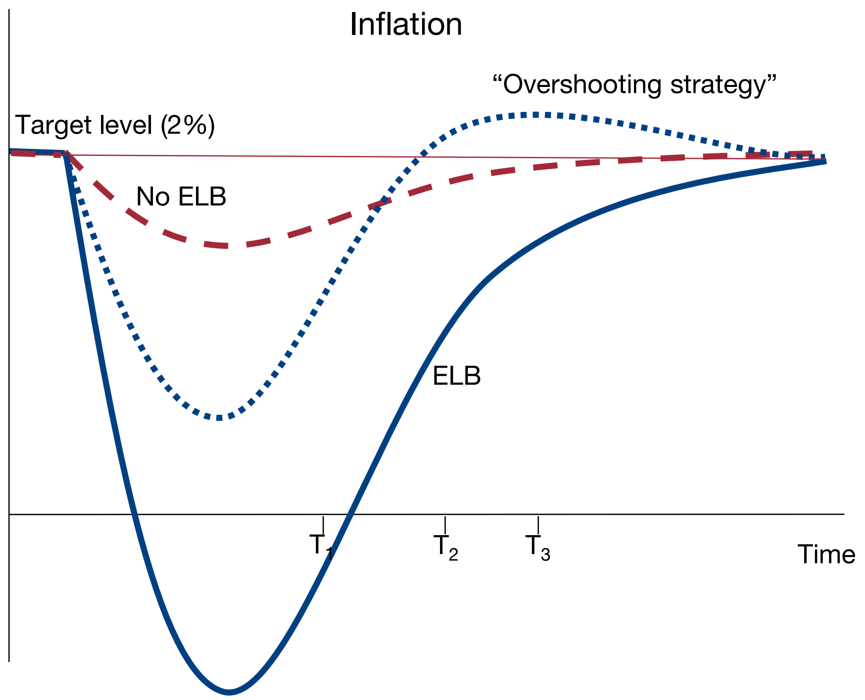
  - **An inflation target of 2% over the medium term, and a symmetric commitment to this target**
    - "Symmetric" means that positive and negative deviations of inflation from its target are considered equally undesirable

  - The need for **especially forceful or persistent monetary policy measures when the economy is operating close to the lower bound** to avoid negative deviations from the inflation target becoming entrenched
    - This acknowledges the importance of bearing in mind the implications of the **lower bound** when it comes to maintaining the symmetry of the inflation target
    - It may also imply a transitory period in which **inflation is moderately above target (overshooting)**

WHY MAY ALLOWING FOR OVERSHOOTING HELP TO ACHIEVE SYMMETRY IN INFLATION WHEN THE ECONOMY IS OPERATING CLOSE TO THE LOWER BOUND?

- By signalling the possibility of future overshooting, and if agents are forward-looking, the central bank can raise inflation expectations
- The resulting fall in real interest rates stimulates aggregate spending and current inflation
- This makes it possible to (partly) neutralise the constraint posed by the lower bound on interest rates and achieve more symmetric fluctuations of inflation around the target



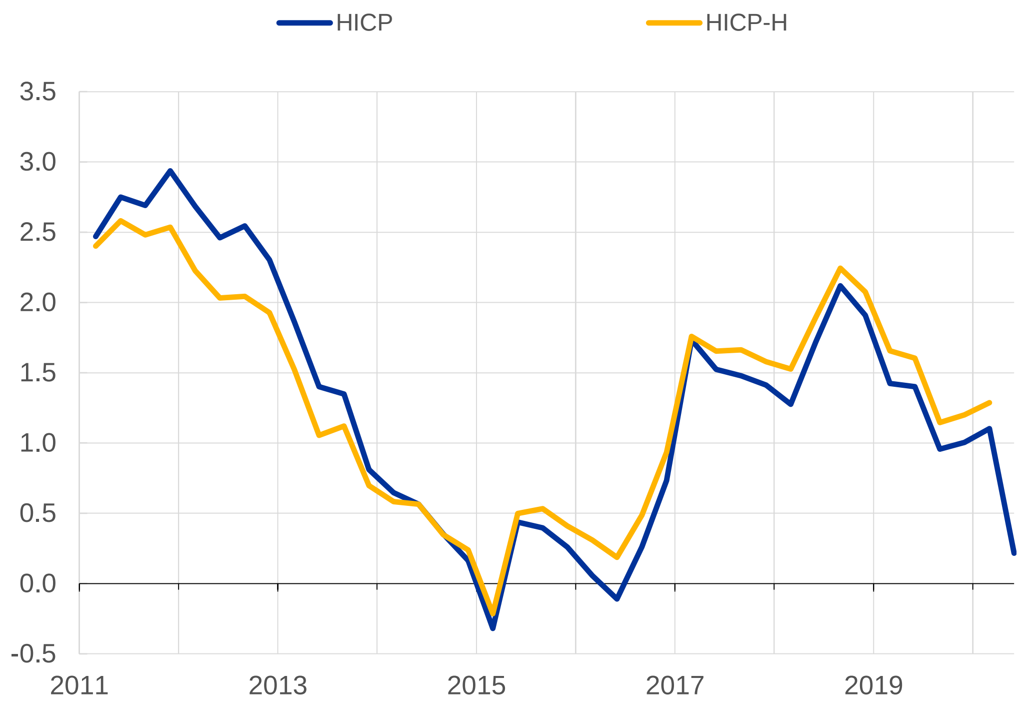


Source: own calculations.

- The **medium-term orientation** of the strategy is confirmed, allowing for inevitable short-term deviations of inflation from the target, as well as lags and uncertainty in the transmission of monetary policy.
    - It also takes into account the origin, magnitude and persistence of the deviations and other considerations relevant to the pursuit of price stability (employment, financial stability).

- **Monetary policy instruments**: the primary instrument is the set of **ECB policy rates**. Other instruments will also be employed, in particular, **forward guidance, asset purchases and longer-term refinancing operations**, as appropriate.
    - **New monetary policy instruments** will be considered, as needed, in the pursuit of its price stability objective.

- The **Harmonised Index of Consumer Prices** (HICP) is confirmed as the most appropriate price indicator for assessing achievement of the price stability objective.
- However, it is recognised that the inclusion of the costs related to **owner-occupied housing** in the HICP would better represent the inflation rate that is relevant for households.
  - Full inclusion in the HICP is a multi-year project. It should allow for distinguishing between the **consumption** and the **investment** element, the former being more relevant for monetary policy.



Source: Eurostat, ECB calculations.

- Monetary policy decisions will be based on an **integrated assessment of two interdependent analyses: the economic analysis and the monetary and financial analysis.**

- **Communication** will be adapted to reflect the strategy review, by means of layered and visualised versions of communication products (monetary policy statement, press conference, Economic Bulletin and monetary policy accounts) geared towards the general public. Outreach events as a structural feature.

- **Periodic strategy reviews**. Next review scheduled for 2025.

- Within its mandate, the Governing Council of the ECB is committed to ensuring that the Eurosystem fully takes into account, in line with the EU's climate goals and objectives, the **implications of climate change** and the transition to a low-carbon economy for **monetary policy** and central banking.

- Commitment to an ambitious **climate-related action plan**: full incorporation of climate factors in its **monetary policy assessments**, and **adaptation of the design of its monetary policy operational framework** in relation to:
    - disclosures,
    - risk assessment,
    - corporate sector asset purchases and
    - the collateral framework.

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AT END-JULY, THE ECB REVISED ITS FORWARD GUIDANCE ON INTEREST RATES TO BRING IT INTO LINE WITH THE NEW STRATEGY

- Previous forward guidance (FG) on interest rates: "*The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.*"

- The new FG incorporates the **symmetric 2%** target, requiring that it be achieved **well ahead** of the projection horizon and **durably** so that interest rates can be raised. It also allows for overshooting and reinforces the condition linked to core inflation:

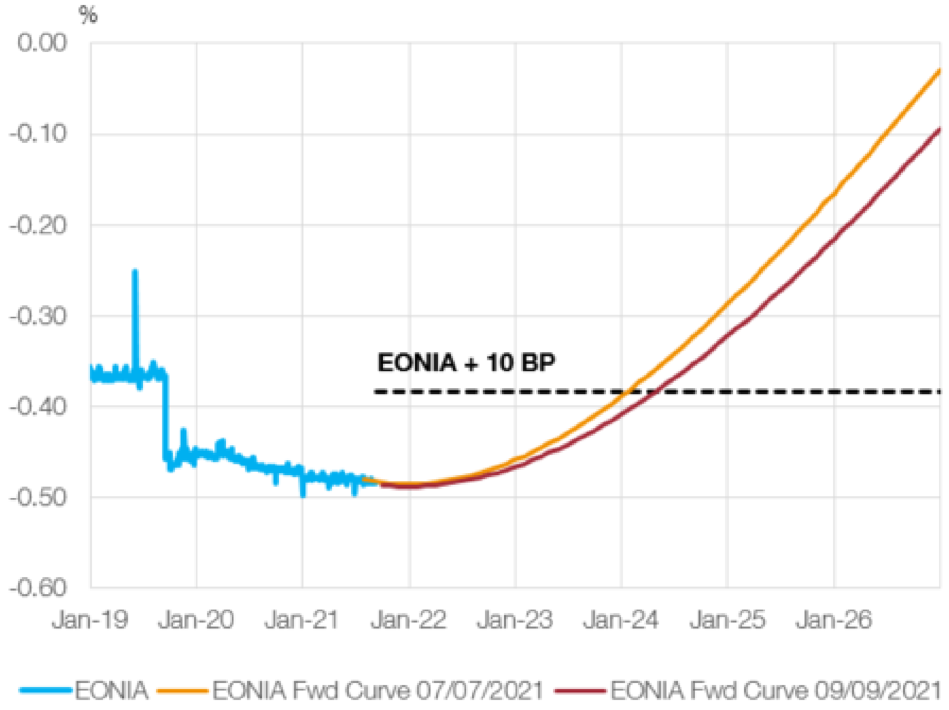
"*In support of its symmetric two per cent inflation target and in line with its monetary policy strategy, the Governing Council expects the key ECB interest rates to remain at their present or lower levels until it sees inflation **reaching two per cent** **well ahead** of the end of its projection horizon and **durably** for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term. This may also imply a **transitory period in which inflation is moderately above target**.*"

- **No changes, for now,** in the FG for other instruments (APP, PEPP, TLTRO).
  - The commitment to adjust instruments is modified from "*The Governing Council stands ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry*" to "(…) *ensure that inflation stabilises at its two per cent target over the medium term.*"

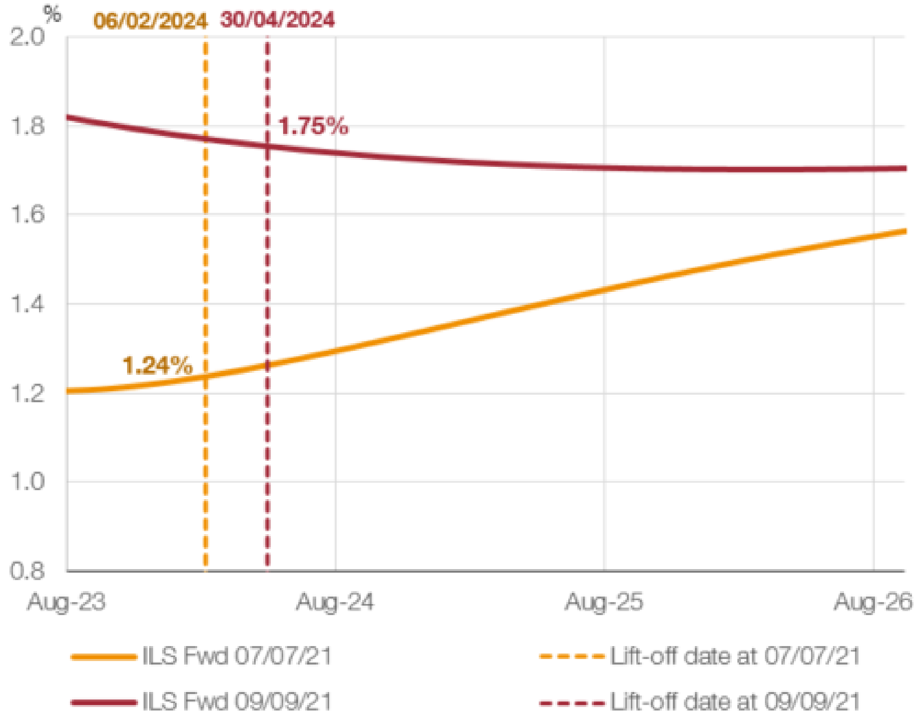
THE FORWARD CURVES INDICATE A DELAY IN THE EXPECTED DATE OF THE FIRST INCREASE IN RATES AND HIGHER INFLATION AT THAT DATE

- In keeping with the new strategy, which sets a slightly higher inflation target, and with the new forward guidance, which establishes more demanding conditions in terms of inflation, to be met before the ECB can begin raising its interest rates.
- In any event, as shown in the case of the Federal Reserve, the financial markets need time to fully process the implications of such strategy reviews of monetary policy.

EURO AREA OIS INSTANTANEOUS FORWARD CURVE



EURO AREA ILS INSTANTANEOUS FORWARD RATES AND EXPECTED LIFT-OFF DATE



Sources: Refinitiv Datastream and Banco de España.

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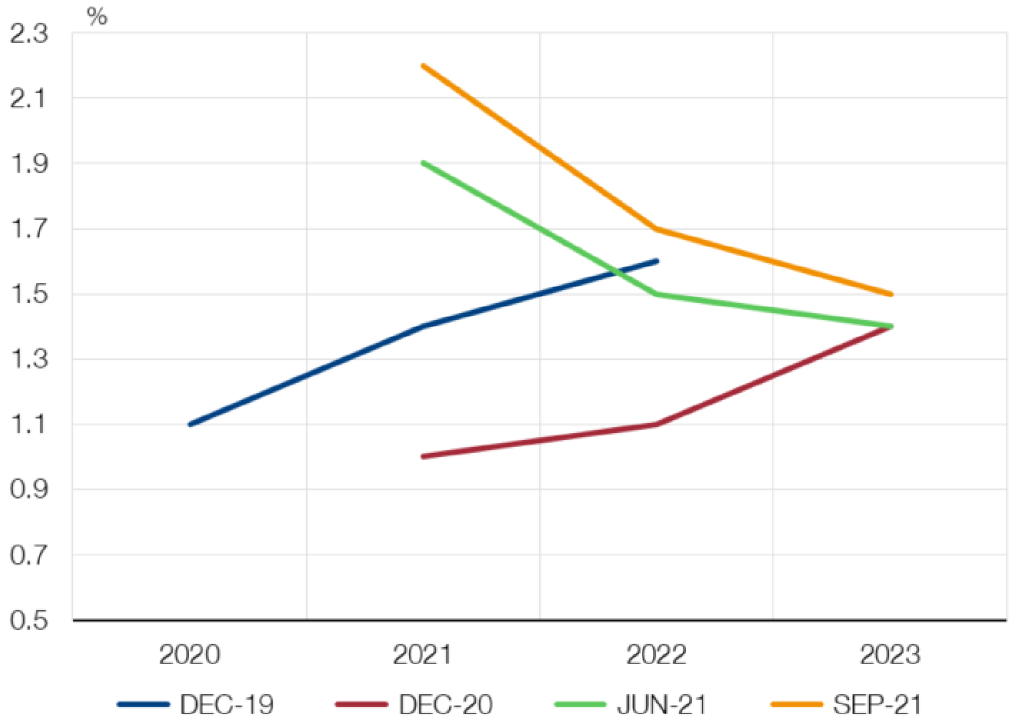
SINCE DECEMBER 2020, ASSET PURCHASES UNDER THE PEPP HAVE BEEN CONDUCTED IN A FLEXIBLE MANNER, IN ORDER TO MAINTAIN FAVOURABLE FINANCING CONDITIONS

- In September, based on the easing of financing conditions (FC) since June and a slight improvement in the inflation outlook, the ECB decided to moderately lower the pace of purchases under the PEPP. However, the recent tightening of financing conditions is a reminder of their volatility and dependence on policy support.
- This decision does not imply the start of a gradual reduction in net asset purchases under the PEPP, known as “tapering”, but a recalibration of the envelope.

10-YEAR SOVEREIGN YIELDS AND OIS

ECB/EUROSYSTEM INFLATION PROJECTIONS FOR THE EURO AREA



Source: ECB.

Sources: Refinitiv Datastream and ECB. Latest observation: 13.09.2021
(a) 10-year sovereign yield weighted by the GDP of the four main economies (Germany, France, Italy and Spain).

THANK YOU FOR YOUR ATTENTION