

ARTICLE – New monetary policy strategy in the euro area

On 8 July, the European Central Bank (ECB) decided on a new monetary policy strategy. According to the new strategy, price stability can best be achieved by aiming for 2 per cent inflation in the medium term. Unlike previously, when the target was for inflation to be below, but close to, 2 per cent, the inflation target is now symmetrical. This means that lasting deviations from target in the medium term, both negative and positive, are equally undesired. This makes the ECB's new inflation target more like the one the Riksbank has. The strategy confirms that the policy rate is still the primary monetary policy instrument but that other instruments used over the last decade will continue to be part of the ECB's tool kit and will be used when deemed appropriate. In its new strategy, the ECB also emphasises the importance of inflation not lastingly falling below target when the policy rate is close to its lower bound and that monetary policy may therefore need to be conducted in such a way that inflation lies slightly above target for a period.

The ECB's new monetary policy strategy also includes an action plan against climate change. Apart from integrating climate factors into its monetary policy assessments, the ECB will weigh climate considerations into risk assessments, the framework for collateral, corporate bond purchases and other activities.

Symmetrical target of 2 per cent inflation

On 8 July 2021, the ECB published the results of its review of the monetary policy strategy.²⁸ The review was initiated in January 2020 and is the ECB's first strategy review since 2003. The strategy will be evaluated more regularly in the period ahead. The next review is planned for 2025.

The inflation target, previously formulated as a rate of inflation below, but close to, 2 per cent, is now symmetrical and has been set at 2 per cent. The aim of the change is to clarify at which level of inflation the ECB is aiming. The new strategy also entails a slight increase in the inflation target. One consequence of the change is that the ECB inflation target will be more like the one the Riksbank has. The symmetry means that both negative and positive deviations from target in the medium term are equally undesired. However, in the short term, inflation will vary as the economy is constantly

²⁸ See the ECB's statement on its monetary policy strategy [The ECB's monetary policy strategy statement \(europa.eu\)](https://www.ecb.europa.eu/press/pr/20210708/monetary-policy-strategy-statement) and *Economic Bulletin*, 5/2021, European Central Bank.

being affected by various unexpected shocks that are not fully counteracted by monetary policy. The ECB points out that the inflation target provides a clear anchor for inflation expectations. Well-anchored inflation expectations make price and wage-setting more stable so it becomes easier to maintain price stability in the medium term.

The ECB emphasises the importance of taking account of the marked decline in the global equilibrium real interest rate as this means that the effective lower bound of nominal interest rates will probably limit monetary policy more often. When the interest rate is close to its lower bound, powerful or sustained monetary policy measures are needed to prevent negative deviations from the inflation target from becoming protracted. This could also mean monetary policy being designed so that inflation is moderately above target for a period.

The policy rate remains the primary monetary policy instrument for the ECB. However, other instruments, such as communication of the likely development of the policy rate (known as forward guidance), asset purchases and long-term lending to the banks, will also continue to be part of the ECB toolbox and will be used as appropriate. Above all, this is the case when the policy rate is at or close to its lower bound. The ECB deems that, in such situations, fiscal policy will also play an important part in macroeconomic stabilisation.

Costs for living in owner-occupied housing to be included in the HICP

The harmonised index for consumer prices (HICP) will continue to be the ECB's target variable, but it is recommended that costs for living in owner-occupied housing be included in the HICP going forward. These costs have not previously been included in the HICP, which the ECB sees as a shortcoming as they stand for a relatively large proportion of total household expenditure. However, integrating these costs into the HICP is expected to be a multi-year project and, during this time, the ECB will use preliminary estimates of these costs in its monetary policy assessments. The Riksbank deems that the effects of the change will be relatively small for the measured inflation of the euro area as a whole, but they may vary somewhat over time and from country to country. The Riksbank's target variable CPIF already includes households' costs for living in owner-occupied housing, albeit measured in a different way than that advocated by the ECB (see the article "Different methods of measuring housing costs in the consumer price index").

Financial stability is a prerequisite for price stability

According to the new strategy, the ECB's monetary policy decisions are to be based on an integrated assessment of all relevant factors, including the proportionality of the decisions. Proportionality means that the intended effects of various monetary policy measures on inflation and the financial conditions are weighed against unintended effects on the real economy and financial systems. The assessment of proportionality also takes into account the uncertainty concerning the effectiveness and side effects of different policy instruments as well as the risk that confidence in the inflation target will deteriorate. The mutual dependency between economic developments, the money supply and other monetary and financial factors shall therefore be analysed

and considered. Consideration of financial stability will be taken in a flexible manner in the monetary policy deliberations. The ECB will therefore neither systematically tighten monetary policy to counteract the accumulation of financial imbalances nor wait to act until the imbalances have possibly resulted in a crisis. Instead, in each situation, the ECB will assess which policy is appropriate based on the prevailing conditions.

Visualised and adapted communication to reach a broader public

Over time, communicating the monetary policy decisions has become more important and affects the efficiency of monetary policy. The ECB is therefore adjusting its communication to reflect the revised monetary policy strategy. To ensure understanding of and confidence in the policy measures among a broader public, the ECB will work with monetary policy communication that is visualised and adapted to different target groups and information channels. It will also make outreach activities a permanent feature of the Eurosystem's contacts with the general public. Examples of such activities include various events for a broader public to explain monetary policy.

Climate-related action plan set out

The ECB has also presented a climate-related action plan. The ECB's ambition is to ensure, within its mandate, that the Eurosystem takes full account of the consequences climate change and carbon emissions may have for monetary policy and central bank activities, and thereby works in line with EU's climate goals. The ECB will improve its analytical and macroeconomic modelling capacity, and develop statistical indicators to understand the consequences climate change may have for the macro economy, inflation and financial stability. Apart from integrating climate factors into its monetary policy assessments, the ECB will weigh climate considerations into risk assessments, the framework for collateral, corporate bond purchases and other activities.