Strategy review: no major change of course

ECB special

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Summary

- The ECB has agreed on a symmetric 2% inflation target, without a specific promise to make up for past inflation misses. Yet, the framework leaves the Council with the option to do so.
- The Council confirms the use of the HICP as inflation benchmark, but recommended that house prices are added to the index.
- All in all, we doubt that these two updates to the inflation aim will mark a meaningful change from the policy implementation in recent past.
- The appraisal of the policy instruments was fairly limited, but we believe the review hints at continued use of TLTROs, and a quicker recourse to PEPP-like interventions when required.
- The ECB has released a climate change road map, with plans to green a.o. CSPP and the collateral framework. Most of this should take effect from 2022/23 onwards.

2%

After 18 months of deliberations, the ECB agreed on an inflation target of… 2% over the medium term. While that probably won't surprise anyone, the key part of the announcement is how the ECB interprets the symmetric nature of this target:

> *"This target is symmetric, meaning negative and positive deviations of inflation from the target are equally undesirable. When the economy is operating close to the lower bound on nominal interest rates, it requires especially forceful or persistent monetary policy action to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target."*[1]

As we noted earlier, the exact phrasing of the target's symmetry was a semantic discussion between *allowing* inflation misses from the aim, and the *intent* to make up for any such errors. The ECB's interpretation reeks of compromise between the two camps in this debate. The first sentence is the text book definition of symmetry: it simply notes that the ECB will have similar *tolerance* to misses on the down- and upside, while the Bank does not make any commitments to make up for the years of below-target inflation.

Yet, the remainder of the paragraph adds that in very specific situations –like the present– it may in fact be desirable to *strive* for above-target inflation for some time. In essence then, the ECB is saying that they may choose to temporarily adopt a Fed-style flexible average inflation targeting approach, but only in certain cases; a ***conditional flexible average inflation targeting (CFAIT)*** **strategy**, if you will? Of course, it remains to be seen how the ECB will implement this in practise; after all we're still a long way off from actually reaching the target, let alone from the point when the ECB can intentionally exceed it. So, arguably, this addition was only made to ensure that the new inflation framework does not sound more hawkish than before.

[1] https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210708~dc78cc4b0d.en.html

Will this significantly change the way policy is set?

Probably not. In our view, the outcome of this review mostly formalises policy changes that have effectively already been implemented over the past few years. In a way, this new approach to symmetry is not unlike recent introductory statements, in which the ECB already stressed its *"commitment to symmetry"* and the hints that it may need to let inflation run a bit hotter in the future. Again, the new definition does not require an overshoot, but it doesn't preclude one either. Moreover, although the goal has now been set, actual inflation has yet to follow.

And what about the communication strategy?

First of all, the new 2% aim is indeed clearer to understand and easier to communicate than the previous *"below, but close to, 2%"*. To that extent, the Council has certainly succeeded. But, ironically, the convoluted description of symmetry has mostly undone these improvements in the inflation target.

We do note that it is yet to be seen how the new strategy will be communicated in the ECB's introductory statements, with the ECB seeking to simplify the language used. Moreover, Ms. Lagarde announced that the policy statement will become more concise, visual, and narrative-based. If forthcoming press releases no longer explicitly include the abovementioned *"commitment to symmetry"* phrase because it is now implied in the ECB's inflation goal, this opens up the risk that markets –or at least algos– initially interpret upcoming statements as more hawkish than the ECB actually intended. With the new framework in place at the 22 July meeting, the exact results of this overhaul should soon become clear.

HICP, including owner occupied housing

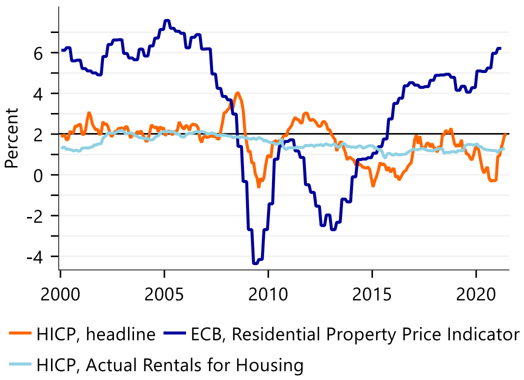
Just as important as the inflation target is the benchmark used to measure it. **The Council confirmed that HICP inflation remains the appropriate measure of price stability, but did recommend the addition of owner-occupied housing.**

However, harmonising house prices across the Eurozone has already proven to be difficult in the past, with varying definitions and measurements available. Moreover, Eurostat, and not the ECB, is in charge of computing and disseminating the HICP indices. Assuming that Eurostat will follow up on the ECB's recommendations, it will still probably take several years to develop a robust methodology to harmonise the way costs of owner-occupied housing are measured in various countries.

Reaching the price stability target sooner?

A bit of a surprise was the announcement that the ECB will, in anticipation of these changes in the HICP index, already start to take currently available measures of house prices into account when assessing monetary policy. Taking the currently available house price indices, that is arguably a slightly hawkish twist: since these indices have outpaced inflation, it implies that the price stability aim should be reached somewhat faster.

Figure 1: House prices versus HICP



Source: ECB, Eurostat

However, as President Lagarde clarified, the ECB intends to only include the *consumer cost* of owner occupied housing, thus stripping out the investment value. When this is done, she argues, the discrepancies between inflation and housing costs are much smaller than suggested by the currently available indices (figure 1). Moreover, the Council will –for now- only take these costs into account, while the headline HICP remains the policy target. **So the actual impact of this on policy probably will not be noticeable until the HICP index is updated, and after that may also be fairly negligible.**

Policy toolkit: unconventional made standard

Although we weren't expecting too much information on policy tools, an appraisal of the toolkit was perhaps the biggest hiatus in today's results. Nonetheless, we draw a few conclusions from today's update.

First of all, the review confirmed that non-conventional instruments will remain an integral part of the ECB's toolkit, *"to be used as appropriate"*. While this doesn't explicitly state that longer-term liquidity operations will become a permanent feature of the ECB's policy, we believe that the case can be made for TLTROs – or similar operations. Considering the increased reliance of banks on ECB liquidity for their funding needs, there probably will be a need for a renewed series of TLTROs in the future.

Secondly, the conclusion that inflation shortfalls may require an *"especially forceful"* policy response when rates are near the lower bound, suggests that a PEPP-like intervention may become more commonplace in future crisis situations. Of course, this still leaves many questions to be answered. Will the PEPP's flexibility will be inherited by the APP? What the ECB's view is on the APP's 33% issuer limits, and how will the ECB deal with the overhang of the PEPP portfolio? Recall that when APP started, the existing Securities Markets Programme holdings were subtracted from the amounts that the ECB could buy in certain peripheral markets.

The biggest omission, perhaps, is an assessment of negative rates, considering their protracted nature. Does the Council still see limited negative side effects or risks stemming from the costs that this imposes on financial institutions, and if they do, is there need for a more effective mitigation of these costs? By comparison, the Bank of Japan's tiered interest rate system exempts a much larger proportion of liquidity from negative rates, while still being largely effective.

Considering that the outcome of the ECB's review does not change the fact that they will have to maintain an easy policy stance in the years to come, these questions will certainly be up for discussion in the not too distant future. The APP parameters will come back to the fore when the ECB intends to phase out PEPP and, as we expect, probably scales up the APP to offset some of the impact. And the tiered deposit rate may need to be revisited when the second TLTRO discount expires in June.

Climate change: not all lights are green yet

Last but not least, with this review the ECB is also acknowledging the rapidly changing environment and specifically the need to play a stronger role in support of preventing and/or to adjust to climate change. As such, climate change will be included in various aspects of the ECB's monetary policy. The ECB sees this as a multi-year project, and has published a road map with the steps that will be taken between now and 2024. This also means that not all of the details are known yet, but aside from including inflation into the ECB's models and scenarios, there are a few areas where this will sooner or later affect markets.

First of all, the road map seeks a *"concrete proposal for alternative benchmarks"* for the Corporate Sector Purchase Programme by next year, after which **the ECB strives to adapt the CSPP's framework to include climate risks by 2022H2.** We imagine that the EU's taxonomy exercise could play a role in developing such benchmarks.

And secondly, the collateral framework will be greened. We see two ways in which the framework will be impacted. **Disclosure requirements will be introduced for eligibility as collateral, and the**

ECB will consider climate risks in its valuation of assets used as collateral. As we understand, the ECB is first investigating if and how climate risk is currently being accounted for by rating agencies, and depending on that result, may implement its own internal ratings – this to ensure that climate risk is included, and not counted twice when calculating the haircuts on asset posted for collateral.

The overall consequences will depend on the actual implementation of its road map. But it is clear from the outset that by introducing disclosure requirements and a possible change of eligibility rules for both collateral and asset purchases, market participants will need to think ahead as this may start to creep into the pricing of assets long before these changes are done and dusted.

The implications of this for monetary policy are harder to fathom, in fact outright speculative. Going too fast on 'greening' may even lead to undesired tightening of financial conditions, but one could also point out that a policy that is too far out of touch with reality (i.e. investor demand for 'green') risks losing its effectiveness in the future.

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