GIAM Macro & Market Research - Market Commentary

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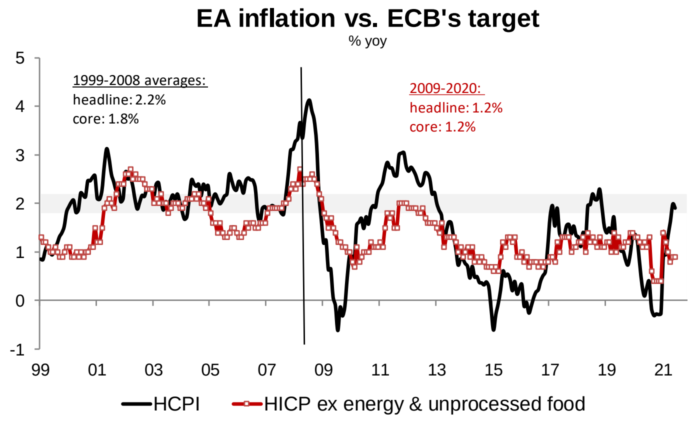
ECB's new strategy: Symmetric, more complex, greener and better explained

- **Today the ECB revealed – surprisingly early - the results of its strategy review, which was unanimously approved within the Governing Council.**
- **Most importantly, it moved to a 2% symmetric inflation target, allowing temporary deviations from this target. The definition of the HICP is not changed but owner occupied housing costs will be considered and shall be included in the index at a later stage.**
- **The ECB will tolerate moderate deviations of inflation from target but does not follow the Fed in its average inflation targeting approach.**
- **Going forward, an analysis of the financial system will complement the monetary analysis. The ECB recognises that close to the effective lower bound forceful and persistent action is needed, suggesting that 'unconventional' measures are now part of the regular toolbox.**
- **The ECB has announced an ambitious climate strategy, but the lack of near-term action and little operational details is slightly disappointing. Credit market should not react to these announcements.**
- **The ECB seeks to better communicate the rationale behind its decisions and already announced the next overhaul of its strategy in 2025.**
- **Overall, this announcement cements a dovish bias but does not endorse extreme changes.**

Today the Governing Council (GC) surprisingly released its new monetary policy strategy. It follows the last update from 2003 and was **approved unanimously**.

Symmetric inflation target: The ECB moved to a symmetric target at 2% replacing the former objective of "*below but close to 2%*". This was largely expected as over the past years the ECB had begun to emphasize the benefits from a symmetric inflation target. Former ECB President Draghi already argued in 2016 that it facilitates the absorption of shocks.

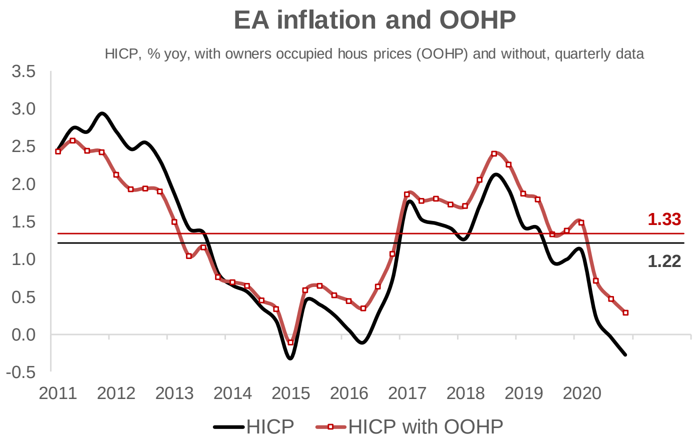


Medium term orientation and financial analysis: The ECB will continue to target a medium-term horizon and will not seek at fine-tuning inflation. Its forward-looking policy will also take into account other factors like employment, financial stability and climate change. This more complex approach will also be reflected by augmenting the monetary analysis by a broader financial analysis in the policy decisions. In our view this suggests that the GC will continue to look at financial conditions as one input for monetary policy.

No AIT a la Fed: Quite importantly, the ECB decided not to follow the Fed and to go for some sort of average inflation targeting (AIT). In the Q&A session President Lagarde made clear that "*moderate temporary deviations*" will be tolerated but not aimed at.

Augmented toolbox: The GC acknowledged that when the effective lower bound (ELB) was reached especially forceful action might be needed to fight deflationary risks. This warrants the employment of formerly unconventional tools, e.g. TLTROs, and it is stated that this may also imply a period of temporary moderate inflation overshooting. This might suggest that the GC is willing to accept more inflation overshooting in this case.

House prices to be included at a later stage: A comprehensive look at inflation also warrants the inclusion of house prices in the measurement of the HICP as owned houses are in part also consumption. Unlike to the US, this is not done in the EU so far. Eurostat's HICP only comprises a weight of 6.5% for actual rentals of housing. In contrast, in the price index the Fed targets it is about 20%. A study for the European Parliament concludes that the inclusion of the cost of owner occupied housing prices (OOHP) would have led to potentially different monetary policy conclusions. Our proprietary analysis finds that since the end of 2014 (when the ECB embarked on QE), the inclusion of OOHP would have pushed headline inflation on average up by 0.3 pp and core inflation even by 0.4 pp (see graph below) while the dynamics is not impacted and longer term the difference narrows to just 0.1 pp. That said, the inclusion of house prices will all other things equal imply a less accommodative or slightly more hawkish ECB.



Ambitious climate strategy but little operational details will limit market impact: As expected the ECB has decided to further incorporate climate change considerations into its monetary policy framework. First through its analytical capacity in macroeconomic modelling, statistics and monetary policy with regard to climate change. But more importantly in including climate change considerations in monetary policy operations in the areas of disclosure, risk assessment, collateral framework and corporate sector asset purchases. Vis a vis corporates the ECB has decided to take a two-stage approach, first asking for enhanced corporate disclosures, before linking gradually the climate profile of companies to both their eligibility to collateral and purchase programmes. Over the second half of 2022 the ECB will adapt the CSPP framework to possibly apply either haircuts or tilting the purchases with regards to the climate trajectory of each company. The ECB has mostly followed the announcement of the BoE but is proving less operational details. Overall, the announcement of the ECB on climate are slightly disappointing as the topic has been intensely covered by governing council members over the recent months. Even the Bundesbank Governor Jens Weidmann, a long-time opponent to the inclusion of climate matters into monetary policy, had called for a more ambitious roadmap during his speech at the BIS Green Swan Conference. Hence, we expect credit markets to remain indifferent to the release near term.

Better communication, next review in 2025: The ECB will seek a better communication, especially to the wider public. Also, the introductory statement in monetary policy press conferences will be shorter, crispier and easier to understand according to Mrs Lagarde. The GC knows the policy environment might change fast and announced the next strategy review already for 2025. This is just after the scheduled completion of the climate action plan and possibly at a time when the HICP will be augmented by the consumption-related occupied owners housing costs.

No surprise and no ramifications for actual policy stance: All in all, there were no major surprises in the release of the new ECB strategy. But while a move towards AIT a la Fed had not been expected stronger signals like relating forward guidance to inflation seemed realistic. That said, we think that the move towards a symmetric inflation target, the emphasize of the medium term for achieving the target and the complementation of the economic analysis by a financial one will leave the GC enough room for manoeuvre. We expect that financial conditions continue to play an important role. House price developments are unlikely to change the picture fundamentally, at least until they are fully integrated into the HICP. We do not expect major ramifications for the actual policy stance and the decisions made at the July 22 GC meeting.

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Key features of the ECB July 2021 strategy review

- **House prices not yet included in HICP target**: The HICP "*remains the appropriate price measure for assessing the achievement of the price stability objective*" but the GC will "*take into account inflation measures that include initial estimates of the cost of owner-occupied housing in its wider set of supplementary inflation indicators*."
- **Acknowledging deflation risks**: "*An inflation buffer above zero per cent provides monetary policy with space for interest rate cuts in the event of adverse developments and a safety margin against the risk of deflation through its positive impact on the trend level of nominal interest rates.*"
- **Symmetric target**: The ECB is "*aiming for two per cent inflation over the medium term. The Governing Council's commitment to this target is symmetric. Symmetry means that the Governing Council considers negative and positive deviations from this target as equally undesirable*."
- **State dependent overshooting**: When the economy "*is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target.*"
- **Medium-term orientation of target confirmed:** The GC made clear that this allows for " *inevitable short-term deviations of inflation from the target, as well as lags and uncertainty in the transmission of monetary policy to the economy and to inflation*" and that "*the appropriate monetary policy response to a deviation of inflation from the target is context-specific and depends on the origin, magnitude and persistence of the deviation. It also allows …. to cater for other considerations relevant to the pursuit of price stability*."
- **Enhanced policy toolbox**: "*The primary monetary policy instrument is the set of ECB policy rates*" but "*In recognition of the effective lower bound on policy rates, the Governing Council will also employ in particular forward guidance, asset purchases and longer-term refinancing operations, as appropriate*" and "*will continue to respond flexibly to new challenges as they arise and consider, as needed, new policy instruments*."
- **Side effects of monetary policy** also considered: "*The Governing Council bases its monetary policy decisions, including the evaluation of the proportionality of its decisions and potential side effects, on an integrated assessment of all relevant factors. This assessment builds on two interdependent analyses: the economic analysis and the monetary and financial analysis*."
- **Climate change: "***In addition to the comprehensive incorporation of climate factors in its monetary policy assessments, the Governing Council will adapt the design of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework*." The ECB developed a detailed action plan to include climate change considerations into its new strategy.
- **Communication:** The current communication will be **"***complemented by layered and visualised versions of monetary policy communication geared towards the wider public, which is essential for ensuring public understanding of and trust in the actions of the ECB*."
- **Regular strategy reviews** are planned with the next one scheduled for 2025.