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ECB: Leaving no stone unturned

This week's comments by Christine Lagarde and Isabel Schnabel signal that the European Central Bank's upcoming strategic review will be very broad in the beginning but could end up changing very little

ECB headquarters, Frankfurt

During her first appearance at the European Parliament as ECB President, Christine Lagarde left no doubt that the ECB will soon announce the start of the first strategic review since 2003. Reading between the lines and also taking into account Isabel Schnabel's comments at her hearing at the European Parliament this week, it appears that the ECB wants to take a broad approach, with no limits. In our view, it is very likely that Lagarde will announce the start of this review at next week's ECB meeting. This is the first ECB policy meeting since Lagarde came into office.

What history tells us

The first and only evaluation of the ECB's monetary policy strategy was in 2003 and took half a year to conclude. Back then, the two main changes to the strategy were the recalibration of the definition of price stability ("below, but close to 2%" instead of "below 2%") and an end to the official reference value for M3 growth (4 ½ % YoY). The new definition of price stability was rather seen as a more technical detail, while dropping the M3 reference value led to a more public reaction as it was seen as cutting the ties with Bundesbank policies.

When speculating about how a new strategic review could look, it is worth having a look at the debate and analysis in 2003. Back then, there were extensive discussions of different inflation measurements, the issue of a single point target or a range for inflation and the concept of an optimal rate of inflation. The argument was made that a lower inflation rate target would increase the risk of deflation. Also, inflation rates clearly below 2% would complicate rebalancing within the eurozone, pushing low-inflation countries into deflation. We wouldn't be surprised to see many of these discussions repeated in a new review, with probably the same conclusions. It is also worth noting that back in 2003, the ECB did not assess or review its monetary policy instruments.

What to expect from the new review

With the experience of 2003 in mind and current (and new) challenges for central banks in a low growth, low inflation and negative interest rate environment, we expect the ECB's review to eventually focus on four main issues: the definition of price stability, how to interpret the mandate, climate change and communication. Here is what the issues are broadly about and our current take on the possible outcome.

- Definition of price stability. While more hawkish central banks have been arguing in favour of lowering the ECB's inflation target, inflation differentials and deflationary risks argue in favour of sticking with or even increasing the target. Also, there should be a discussion about a single point target versus a range and the question of whether the ECB should tolerate an overshooting of its inflation target to make up for a period of undershooting the inflation objective.

In our view, this discussion will show many parallels with the 2003 debate. Inflation differentials and deflationary risks argue against lowering the inflation target. It is possible the ECB will announce that it plans to work with Eurostat to include housing markets in a better way than only using rents, such as including imputed rents in the consumer price index. More importantly, we see a redefinition of price stability to "around 2%" as an elegant way to keep maximum flexibility and open the door to allow for inflation overshooting.

- Changing the mandate and including climate change. Recently there have been calls on the ECB to include measures to tackle climate change. These calls received more support in Lagarde's latest comments at the European Parliament.

In our view, the ECB's mandate is laid down in the European Treaties and cannot be changed by the ECB. Governments will also have no interest at all in changing the mandate. Consequently, maintaining price stability will remain the ECB's primary mandate. Having said this, the ECB's secondary mandate is to support "the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union". This leaves enough room to support the European Commission's ideas for a New Green Deal, for example by taking "green" factors into account in the ECB's quantitative easing purchases, investments in its pension fund and incorporation in its economic models. At the same time, the ECB seems to be pushing rating agencies to include climate and sustainability in ratings, a much easier option for the ECB.

- Communication. A lot has been written about possible changes to communication. Ideas like dot plots or releasing voting records have been around for a while.

In our view, there is currently very little appetite for making voting more transparent. It normally is not very complicated to find out who was in favour and who was against certain policy decisions.

The risk of more transparency is a further rift and re-nationalisation of the Governing Council. Including a dot plot, the ECB's own interest rate expectations, however, could be one outcome of the review, strengthening forward guidance. As the ECB wants to communicate more often and better with the broader public, the start of a series of roundtables or other kind of interaction could be an easy win and outcome of the review.

Many stones to turn but no mountain of change

Currently, Lagarde is trying to give the impression that no stone will be left unturned and that the review will be extremely broad. We don't expect any conclusion of such a review – which has not even started yet – before the second half of 2020. Our current guess is that expectations should not be set too high. A change of the price stability definition to "around 2%", along with some incorporation of climate change and more communication transparency looks like a possible outcome. However, before any of these conclusions materialise many stones will have to be turned.

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