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Economic Insight

ECB strategy review – don't waste the chance

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The ECB wrongly plays down the relevance of the upcoming revision of its monetary policy strategy. A comprehensive revision is needed to implement the lessons learnt from the recent inflation shock.

At first glance, the upcoming revision of the ECB's monetary policy strategy next year is merely a matter for experts. But far from it! It is about the important question of how the ECB intends to prevent another inflation shock in the future. I suggest four changes to the monetary policy strategy.

Inflation: from point target to target range

Firstly, the ECB should revise its definition of price stability. So far, it considers its target reached when its medium-term inflation forecast is two percent. But no central bank in the world can control inflation with such an accuracy. They regularly fail on this overly ambitious target, which negatively affects their credibility.

A target range of plus/minus 0.5 percentage points around two percent would be superior to a point target. This would not only enhance the ECB's credibility, but would also make its monetary policy more stable. If the forecast inflation rate deviates only slightly from two percent, it would not be forced to take bold countermeasures. As in September 2021, it must not justify the use of instruments such as negative interest rates or broad-based bond purchases only because it forecasts an inflation rate of 1.9% rather than 2.0% in the medium term. In view of the high forecasting uncertainty, this is abstruse.

Symmetrical instead of asymmetrical use of instruments

Secondly, the ECB should no longer implement its monetary policy instruments asymmetrically. Until now, the ECB has reacted more strongly to an inflation rate below two percent than to one above. It justifies this asymmetry in the use of tools by arguing that if inflation is too low, the economy could slide into harmful deflation with falling consumer prices, from which the ECB would hardly be able to rescue it.

However, such deflationary traps can hardly be observed in economic history. For example, the Bank for International Settlements (BIS) has shown that phases of falling consumer prices during the gold standard (until the outbreak of the First World War) and since the end of the Second World War have been accompanied by rising and not falling GDP. The frequently cited Great Depression in the USA in the 1930s is not a good counterexample because the falling prices were not the cause of the economic crisis, but the result of a shortage of money triggered by the collapse of around a third of US banks.

Hence, if inflation below two percent is not a bigger problem than inflation above two percent, then the ECB should revise its monetary policy strategy and use its instruments symmetrically in the future. It should use bold measures such as negative key interest rates or large-scale bond purchases only in emergency situations. Conversely, it should not wait too long in the event of rising inflation, as it did in 2022, simply because inflation had previously been below two percent for a long time. The ECB's delayed action is one reason why inflation has risen so sharply.

The ECB should no longer ignore the M3 money supply

Thirdly, the ECB should once again pay more attention to the M3 money supply, which includes cash, checking and savings deposits and other liquid assets. At present, unlike at the Bundesbank in the past, the money supply no longer plays a role in forecasting future inflation risks. However, at the beginning of the coronavirus crisis, the strong growth in the money supply was a harbinger of a significant rise in inflation. It indicated that the ECB was financing the finance ministers' extreme spending policy by buying government bonds on a massive scale. Strong aggregate demand met with a corona-related drop in aggregate supply, which set inflation in motion even before Russia's attack on Ukraine. The ECB should therefore reassess the relevance of money supply when revising its monetary policy strategy and take it back into account in its inflation forecasts alongside other factors such as wage costs and energy prices.

Ending green monetary policy

Fourthly, the ECB should end the so-called green monetary policy. With this policy it is damaging the climate policy instrument that should be at center stage: a uniform CO2 price, which is best determined by trading in emission rights, in which the EU reduces the amount of climate-damaging emissions year by year. The CO2 price ensures an economically sound climate policy by separating efficient from inefficient CO2 reduction investments. If it is cheaper for a company to reduce emissions than to pay the carbon price, then the climate protection measure is cost-effective and should be implemented. Conversely, an inefficient CO2 reduction investment should not be made.

This efficient price mechanism is distorted by the ECB's green monetary policy. By preferentially buying bonds from climate-conscious companies, for example, it reduces the financing costs of such companies compared to other companies. Implicitly, it creates an additional CO2 price that distorts the uniform CO2 price. As a result, some of the expensive CO2 reduction investments appear advantageous and are falsely realized, while cheaper ones are not. In the end, not more emissions are prevented, but the savings are made in the wrong place. Green monetary policy is inefficient and should be abolished. [1]

Altogether, there is a lot to do in the upcoming revision of the monetary policy strategy. ECB President Lagarde recently wrongly downplayed its importance. There is still enough time for the necessary major revision.

[1] "**The green monetary policy illusion**", Economic Insight from 9 June 2021.

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