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ECB strategic review
What, why, how? 10 critical questions for the strategic review

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17 January 2020

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Making sense of the ECB policy review

- 2020 is set to be a crucial year for the ECB as it will review its monetary policy strategy / framework.

- At next week's ECB meeting, the ECB is widely expected to officially launch the review. So far, few members of the ECB's Governing Council (GC) have shared their views on the strategic review, although ECB President Lagarde said that they will leave no stone unturned and that they aim to conclude it by the end of 2020. However, we find the timeline on the ambitious side given the complexities of this exercise. We expect a conclusion in the course of 2021.

- The few GC members' views on the outcome of the strategic review that we have heard are, amongst others: Villeroy (FR) favours symmetric inflation target, similar to Rehn (FI); Knot (NL) favours symmetry around the inflation target (unknown if tolerance or target band); Weidmann (DE) sees no reason to tinker with the aim and Holzmann (AT) favours lowering the inflation target to 1.5%.

- We believe the **ECB's overarching strategy should be to ensure robustness and flexibility in the objective of price stability.**

- Further, the ECB will focus on its ability to guide end-users with a strong, credible and transparent commitment, while acknowledging that some flexibility should be expected given the nature of steering inflation.

- In the following, we examine ten key questions on the upcoming review:
  1. Review – why do it now and what is the timeline?
  2. What is so magical about the 2% number?
  3. What's in scope of the review?
  4. How to measure inflation and what inflation measure to target?
  5. What inflation target regime could we expect?
  6. How do they decide and vote?
  7. Will climate change and sustainability be included in the review?
  8. Will the ECB start to communicate in another format, such as individual votes?
  9. Does it impact credibility and what implications will it have for the toolbox?
  10. How to trade the review?

We conclude that the ECB will decide to apply a symmetry with a potential tolerance band around the inflation target mid point.

1. Review – why now and how?

- In our view, a strategic review of the ECB's monetary policy framework has been long overdue. We welcome a central bank that regularly discuss and reviews its monetary policy objective. The ECB has reviewed its objective once, in 2003, only four and a half years after the inception of the ECB.

- The ECB has a single mandate according to the Treaty of the Functioning of the EU (TFEU) article 127: **the ECB should maintain 'price stability', but it is at the discretion of the ECB's governing council to decide on the precise definition on how they aim to achieve this goal. That also means that as long as the governing council stays within the limits outlined in the TFEU, it is up for the GC to decide.**

- Originally, the ECB's objective was defined as a 'year-on-year *increase* … below 2%', i.e. pre-2003 it should be seen as a 2% ceiling for inflation, also with a commitment to avoid deflation. The 2003 clarification to 'below, but close to, 2%' was to communicate a preference for inflation rates in the upper end of the range. While the 'below, but close to, 2%', has been vaguely interpreted by parts of the financial industry, the former ECB chief economist at that time, **Otmar Issing, said that the intention was to have headline inflation in a 1.7-1.9% range** in their forward looking monetary policy.

- In recent years the ECB has had a hard time achieving the headline inflation rates at these levels over the medium term, and questions of the Phillips curve being dead or alive and structural changes to the global and euro area economy have been posed. Further, the composition of the consumer basket and the effects of the global economy also warrant a review.

- Even though the ECB has had a troubled time in achieving their objective in headline inflation in recent years, they have met the mandate as outlined in the TFEU if we consider measures on underlying (core) inflation, which has been in a tight range of 0.7-1.3%.

- The 2003 review, was coined as a 'clarification' and not a new definition. The rationale for the evaluation was manifold and included comments from academics, analysts etc. Importantly, the perception of an asymmetry of inflation outcomes (above or below 2% was not equally desirable) was a decisive factor. The clarification exercise lasted from October 2002 to the final published details in May 2003.

2. Why 2%?

- The 2% numerical value may as such be an arbitrary level, but there are some economic arguments for that number and why it is not 2.5% or 1.5%.

- Historically, the confirmation of the below 2% target was seen with pride in the late 1990s compared with the high inflation rates in the previous decades.

- The 2% number was chosen to provide an adequate margin to reduce the probability of deflation, and the room to manoeuvre has previously been important due to the practical limits of rate cuts. During the 1990s, the global central bank consensus of inflation targeting pointed to the 2% level, which made the ECB's discussion focus on 2%. However, the ECB originally opted for a more open definition that was intended to be relevant across difference economic regimes, but may also have been influenced by external circumstances, such as the path dependence of the previous inflation rates. Since 1994, Banque de France defined its price stability target to be 'below 2%'.

- The numerical value is not set in stone and can be changed. Most recently in 2018, Norges Central Bank lowered the target rate to 2% from 2.5%.

- The background material for the 2003 review showed that studies indicated that the probability of rates hitting the zero lower rate bound was small when the inflation objective was set above 1% (it happened with a '7% frequency, or equivalently, once every 14 years. With a target of 2% this frequency falls to 2%').

3. What's in scope?

- **The short answer: everything is in scope.** At the December press conference, ECB president Lagarde made it clear that they will turn 'each and every stone' for the review. That also means that both the objective, the communication, the strategy and the framework will be discussed.

- Furthermore, the review will also include technological change and climate change aspects.

- Lagarde further said in the December press conference that they will also reach out to the 'usual suspects', such as members of parliament (particularly the European Parliament), the academic community and civil society representatives.

- Generally, we argue that there are two ways to do it:
  - a short and brief review (clarification similar to 2003)
  - a large overhaul

	Minor revision	Large overhaul
Strategy review	Changing mandate to pre-2003 definition of 'below 2%' HICP or clarification of symmetry	All 'price stability' definitions possible (medium-term, average inflation, price level target). All target variables fulfilling 'price stability' (HICP, core, super-core)
Market impact	Unknown. Will depend on outcome of the	Unknown. Will depend on outcome of the exercise
Time horizon	6-9 months	12-24 months

Source: Danske Bank

- ECB chief economist Lane said to Bloomberg in December that 'the best type of review has a clear focus, knows its ambitions, and it's not so extensive that it becomes impossible to conclude.'

- We believe the attempt to conclude this exercise by the end of this year is optimistic. While we do not envisage the ECB will do a minor revision, we expect the timeline to be extended into next year.

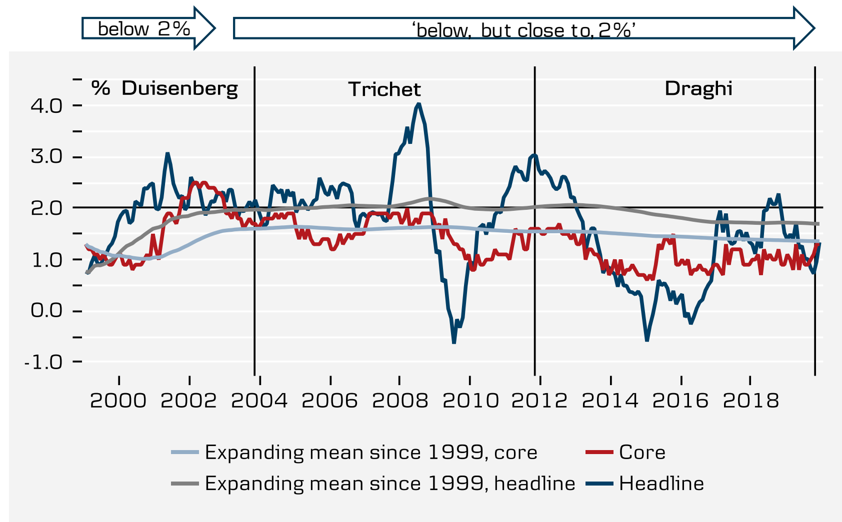
4. How to measure inflation and what inflation measure to target?

- Formally, the ECB is targetting HICP headline inflation over the medium term. De facto, that means that core and other measures of underlying inflation (such as super-core), which capture slower moving trends underlying the economy, is a better gauge for ECB monetary policy. This is due to the complexity of gauging energy and food price swings 2-3years ahead.

- Therefore, as a recent ECB paper puts it on core and underlying inflation 'is a good guess about the level around which headline inflation is likely to settle tomorrow'

- Should the ECB then change officially to target core inflation (similar to the Fed which targets core PCE)? The answer is not that simple. The most important point is that the target should be the most relevant to the consumer. That also means some of the deficiencies of the current definition of headline inflation, which do not take into account asset price inflation or house price costs.

- The classical example is the HICP only capture housing costs via the rentals (6.5% weight), however, owner-occupied housing is not even in the index, despite more than 65% in the euro area owning their prime residence.



Source: ECB, Eurostat, Macrobond Financial, Danske Bank.

- **We expect the ECB to continue to favour headline inflation as the prime target**, over the medium term. However, we do also expect the ECB together with Eurostat to examine the possibility of reviewing the HICP inflation basket and, for example, trying to include owner-occupied housing, which the December ECB meeting minutes hint at.

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5. What regime should we envisage?

- It is difficult to gauge what regime the ECB will end up adopting, and in turn also the monetary policy implications.
- However, we have a firm view of symmetry being clarified yet potential flexibility around the numerical value is still up for debate.
- **Ultimately, the target should be seen as credible.**

Towards PLT (in low inflation period)

- More active central bank
- Narrow strategy / strong commitment
- Small inflation probability outcomes
- Long-term horizon
- Dovish GC members favours this

Price level target (PLT)	Numerical symmetric value	Tolerance band	Target band
After a period of undershooting, inflation will be allowed to overshoot	Symmetric: High and low inflation are equally bad	Numerical value of a symmetric band with small deviation acknowledgement of deviations are inevitable	Numerical value of a symmetric band with potentially large range No action as long as inflation is within band

Our baseline

Towards target band (in low inflation period)

- Less active central bank
- Broader definition / mandate / 'Weaker' interpretation
- Wide range of probability
- Short to medium-term horizon
- Hawkish GC members favours this

More accommodation ⟷ Less accommodation

6. How do they decide or vote?

- As stated earlier, it is up to the ECB's GC to decide on the interpretation of price stability.

- **There is no official guidance on how they will decide or vote on the procedure.**

- In 2003, the ECB GC (of then 18 members, which all had voting rights at all meetings) decided on the new formulation 'below, but close to 2%' with a **strong consensus**. While this may not be necessarily the same this time, **the precedence of deciding without anyone having a blocking minority is important and as such the adoption of the new framework does not need to be unanimous.**

- In 2003, the discussion didn't immediately lead to a unified view as there were 'those who pleaded for an even tighter interpretation. There were others who pleaded for a looser interpretation.' However, the GC concluded that they would create a credibility problem if they were to change the definition and as a result, the GC adopted a clarification of the mandate.

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7. Climate change in the review?

- It is without question that ESG is important for many institutions, and the ECB is no different. The green transition has been particularly in focus since Lagarde's nomination process to succeed Draghi started.

- While our view is that the ECB should naturally support such initiatives, it is not up to the central bank to drive the transition, as the EU has plenty of institutions whose mandate is closer to the ESG debate, such as the EIB or the new-found EU budget of EUR100bn to support the green transition.

- That said, **we do believe that the outcome of the strategic review will entail considerations related to climate change and sustainability**. Lagarde may find backing in the TFEU article 127 (that defines the ECB's single mandate) which also reads '...Without prejudice to this, the ECB also supports the general economic policies of the Union in order to contribute to the achievement of the Union's objectives'. Most recently, the Villeroy de Galhau has been advocating a French bank-wide climate stress test.

- This topic will undoubtedly create debate as to what lengths the ECB can go with supporting the 'general economic policies'. Naturally, a central bank should be wary of structural changes to the economy, but as such the EU has a large number of institutions whose mandate is closer to the climate effort than the ECB (such as EIB and EUR100bn, see above). While, we generally believe that the ECB will not now play an decisive role given the high investor appetite for ESG investments, the ECB should focus on the single mandate. That said, with Lagarde as president, we cannot rule out a more prominent role for green in the ECB going forward and some considerations about climate change may be expected.

- In October last year, Bundesbank president Weidmann said that bond purchases focusing only on green bonds (green QE) could overburden the ECB. He argued that the green / sustainability transition is a structural change, while QE should only be used to address a cyclical situation.

8. Will the ECB start to communicate in another format, such as individual votes?

- While all is in scope, we cannot rule out the possibility of the ECB changing its communication strategy – similar to what they did in 2003, when the two monetary pillars (economic and monetary analysis) were presented.

Monetary pillars

- Most recently, monetary analysis has received less attention in financial markets than economic analysis, due to its longer-term nature. Going forward, we still expect monetary analysis to be part of the ECB guiding variables, although probably in a slightly less prominent role. That also means that we expect economic analysis formally to step more into the forefront of ECB guidance.

Votes

- **The GC works on a collegial basis and we do not expect the ECB to publish individual votes, in the manner of the Bank of England, or the dot plot of the Fed.**

Press conferences

- We do expect the chief economist will join the ECB press conference guiding on the economic analysis.

9. Does it impact credibility and what implications will it have for the toolbox?

- Changing the mandate, when inflation is not on at target, also raises concerns about the timing of the review and the ability to reach the target. Provocatively, one could say that it raises questions about moving the goal post. That said, **we strongly believe that the ECB can change strategy and still remain credible, if they acknowledge inflation symmetry, yet also highlight the flexibility needed to live up to its mandate (target / tolerance band is needed).**

- That also means that changing the numerical value creates problems, as lowering the numerical value could create a precedent for changing it every so often. On the other hand, raising the inflation target, when having had a difficult time reaching the target in the first place, is not credible. Coeuré shared similar reflections in his farewell speech in December.

Implications for the toolbox

- **We believe that the ECB will also try to be more transparent and clarify what measures are in the toolbox, and confirm that negative interest rates and asset purchases are conventional measures**.

- That said, when the next downturn comes, we should not underestimate the ECB's ability to create new measures if needed. We illustratively refer to the ECB's ability and commitment as the player, referee and the rule maker when it comes to its commitment to stimulate the economy.

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10. How to trade the review?

- **The uncertainty regarding the outcome of the strategic review is still high, and with no clear view on the implication for outright levels, it is very difficult to trade the review. However, we highlight that trading the strategic review as a stand alone at the current stage should be seen as trading a tail risk.**

- We will carefully monitor the process and revert later this year with trade recommendations. Until then, we highlight that previous experience has led to higher uncertainty, which also means that we should expect higher volatility.

- Given the long time period ahead of the review's conclusion, should one consider trading the strategic review now, we see the option space as the most relevant, particularly the top-left (short expiries) of the volatility grid.

- We note that given the recent sell-off where implied volatility has declined, we would favour expiries in the 1.5-2y segment with tenors up to 5y, but also acknowledge the slightly negative carry (-7bp on 3m). Further, we favour payers, compared with receivers.

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Date of first publication

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Report completed: 17 January 2020, 10:13 CET
Report first disseminated: 17 January 2020, 14:00 CET