18 June 2021

ECB Research

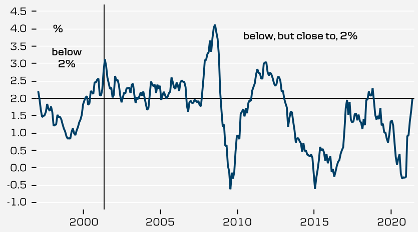
Strategy Review – 'leaving no stone unturned'

- The ECB's Strategy Review that President Lagarde initiated shortly after taking office in November 2019 is approaching its end. After being delayed due to the pandemic, Lagarde was asked on Monday this week if the conclusions could be reached by end of Summer, to which she replied 'I hope so'.
- We expect the inflation target being clarified to be **2%, symmetric and flexible in its understanding on the medium term orientation**. We believe that increased focus on sustainability will also be emphasized.
- As we neither expect ECB will develop new instruments that will make the achievement of the inflation target more probable, nor move the inflation objective closer to the current inflation rate objective, we do not see the probability of ECB meeting its inflation objective to be altered due to the strategic review.
- **Market reaction to the outcome of the strategic review is likely going to be rather muted.** From a market perspective the key focus will be the formulation of the inflation objective and the monetary policy toolbox discussion.

Strategy review timeline

- Dec19: Launched
- 12 (later 13) work streams identified
- Fall 2021: Expected end date
- 28-29 Sep 2021: ECB Forum to 'explore the outcomes'

Inflation has mostly been below the target since the financial crisis



Source: Eurostat, Macrobond, Danske Bank

Staying within the Treaty

ECB GC members have several times said that Treaty changes were not in scope for this ongoing strategy review. This means that ECB will focus on its prime mandate which it is to '*maintain price stability'*. However, Article 127 of the TFEU also say that *'Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union…*', which essentially also means that the EU's focus on sustainability is also an element that ECB needs to take into account when conducting monetary policy. Furthermore, this also means that contrary to other central banks, the ECB mandate is quite narrow and as such does not entail an explicit employment mandate.

What we expect ECB will do

For the strategy review, ECB has identified *13 work streams* that focus on various topics ranging from the price stability objective, inflation measurement over communication and climate change as well as digitalisation. We address key questions below:

- **Price stability objective:** We expect a formulation of the objective to be symmetric around 2%. In recent years, ECB has faced criticism of an asymmetric understanding of its 'below, but close to, 2%' formulation it has had since 2003 and a clarification of the objective should end such discussions. As we discussed in our initial piece published shortly after the launch of the strategy review: *ECB strategic review, What, why, how? 10 critical questions for the strategic review*, 17 January 2020, we expect also a flexible understanding on the 2% target entailing an understanding of inflation not always being on target but hovering around the 2% level. This should provide the ECB with sufficient flexibility to calibrate its monetary policy to a holistic view about the euro area, still focussing on inflation, but without being 'locked' due to a specific

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rule. This may also mean that the medium term orientation still holds. Contrary to the Fed's FAIT regime which incorporates an explicit targeting of overshooting the 2% level, we expect ECB to use a less aggressive target to 'accept', and not 'target', inflation overshooting.

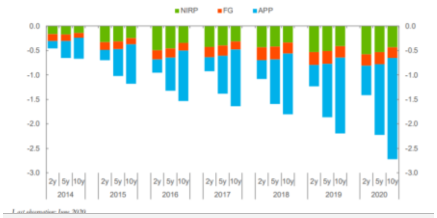
What measure and how to measure inflation? This is a critical question of the strategy review. In recent years, the de facto inflation measure ECB has used for its medium term objective is the underlying core inflation rather than its de jure headline HICP inflation. We expect it will still be the headline inflation that will be the guiding measure. As Eurostat is responsible for the exact computation and content of the HICP basket, it is out of the hands of the ECB to set the exact composition. However, much discussion has focused around the potential inclusion of the owner occupied housing, to better account for the rapid increase in house prices observed in recent years in many euro area countries.

As we discussed in *Euro Area Research - Housing inflation: Opening Pandora's Box*, 6 February 2020, the inclusion of owner occupied housing would not materially change the dynamics of the HICP basket, and only contribute to lifting the inflation profile with on average 0.1pp, i.e. more of a parallel shift in the numbers. Furthermore, the consistency of the data quality to have reliable data on a monthly frequency across the euro area have often been a source of criticism and reason for not including it in the first place. Hence, even in case of a renewed push by the ECB to include owner occupied housing in HICP, it will likely take at least 1-2 years for Eurostat to implement the changes in practice.

- **Standard policy toolbox**: A key focus of the strategy review, notably by markets. ECB's monetary policy is currently operating along four avenues – all of which we expect to continue. ECB research has found that the bond buying programme dominate the impact on the financing conditions via the term premium *here*.
  - *Bond buying:* QE will definitely receive the utmost attention in the strategy review. We believe that ECB will make clear that bond buying is an integral part of the standard toolbox that may even come in use more often as the policy rates are closer to the effective lower bound. This is the case for the APP, with the self-imposed ISIN and issuer limits, where proportionality is the key determinant.

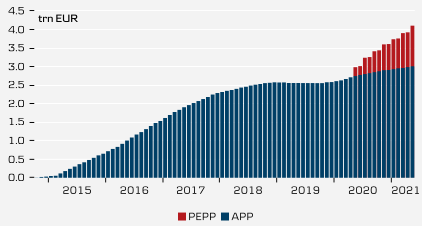
    We do not expect that PEPP-style calibrated bond buying with intentional deviations from the capital key, and ISIN / Issuer limits will remain a key feature of standard bond buying, however, we expect ECB to keep the door open to allow such programmes to be used in case of 'black swan events' such as a pandemic. That also means that we do not expect PEPP modalities to be transferred to the APP as a rule, once PEPP is set to end by the end of March next year.
  - *Liquidity operations*: With excess liquidity in the Eurosystem standing at more than EUR4trn, the liquidity operations are very important to ECB and markets for the transmission mechanism. The current 1w and 3m operations see only limited take up as the significantly more dominating TLTROs are a flagship instrument. With more than EUR2trn of outstanding TLTRO funds, the measure and calibration of modalities has proven important. The dual interest rates (with the lending rate lower than at the deposit rate) set as a pandemic calibration, we expect TLTRO modalities eventually to return to the pre-pandemic calibration of the lowest rate being the deposit rate, and this already from June 2022. This would be in line with changing the tiering multiplier (below).

Estimated impact of ECB's recent policy responses



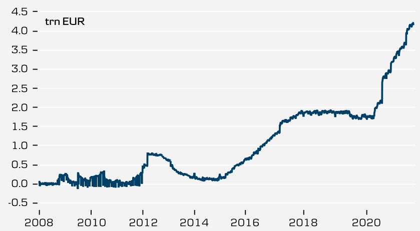
Source: ECB working paper

Bond buying holdings



Source: Macrobond, Danske Bank

Excess liquidity has risen markedly since the pandemic



Source: ECB, Macrobond and Danske Bank

- *Forward guidance, FG*: FG has been an integral part of the toolbox for many years and is unlikely to change. However, the Odyssean, Delphic and Aesopian forward guidance style that was used during former ECB president Draghi's tenure could be revisited. Currently the forward guidance of policy rates is linked to judgements and forecasts of the future path of inflation. That may change, by f.ex. linking FG more closely to realised inflation.

- *NIRP*: We expect for ECB to conclude that the negative interest rate policy is still an important ingredient in the toolbox and that NIRP supports the transmission mechanism with the merits outweighing the negative side effects, with a clear communication that the reversal rate (without being number specific) has not yet been reached. A revisit of the tiering multiplier calibration may not come in connection with the strategy review, but shortly thereafter. We find Villeroy's suggestion of a rule-based approach to the tiering multiplier (net of TLTROs), thereby adapted to the 'low for longer' rate narrative as quite intriguing. However, we are confident that any recalibration will be done without exerting upward pressure on front end rates, thereby tightening the financing conditions. As Villeroy further said that '*Implementing a rule-based tiering multiplier, ..., could make it easier for us to get rid of some possibly excessive subsidies in the present design of TLTRO, and also limit the room for carry trades.*'

- **Climate change:** Since Lagarde took office, the climate change agenda has seen increasing focus by the ECB and markets. ECB argues that it falls under the ECB mandate both due to the impact on price stability via changing consumer / companies behaviour but also as they need to support the overall objective of the EU, see page one. Furthermore, ECB board member Schnabel has vigorously argued that if markets do not adequately price green / sustainability ECB may have a role to play (from market neutrality to market efficiency). We find it very likely that 'green' will have a prominent role in the strategy review outcome, but avenues on how to conduct it may still have to be examined.

  - *No targeted green QE:* First and foremost, it is important to highlight that ECB is already buying green bonds as part of the ongoing QE (PEPP and APP). However, given the still limited outstanding amount of ESG bonds, liquidity and turnover, we do not expect ECB to allocate specific volumes in the QE to ESG bonds to avoid imposing an adverse effect on bond markets as notably ESG bond investors are usually less price sensitive given the portfolio mandates.

  - *Green TLTRO*: In September last year, *Lagarde* was asked about a green TLTRO to which she said that '*is a matter that is of interest and that we will look at*'. The idea behind the Green TLTRO is to provide even cheaper funding rates than the usual TLTRO if the funds are used for green initiatives. We find the approach of using existing liquidity operation setup such as the TLTRO for sustainability also as being quite interesting, but we these a low probability for an actual Green TLTRO, as such subsidy is more a government role than ECB role.

  - *Green collateral haircut*: A key cornerstone in our view of ECB's effort to support a greener economy, and also something that several key ECB GC members has voiced support for. We expect to see a green haircut discount for the collateral used in ECB's general liquidity operations. So far no indication of the size of such haircut was voiced, but we expect a moderate discount.

  - *Taxonomy:* While we expect a green collateral haircut in all of ECB's operations, the taxonomy is still under development. That also means that the change may not come already now, but only at a later stage as the model framework is still being discussed.

What we hoped that they would also do address, but unlikely for several reasons

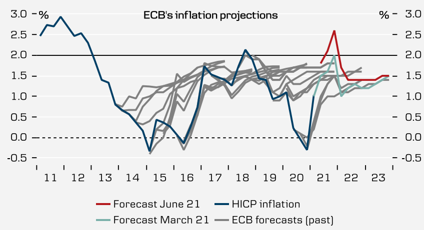
EU institutional setup and coordination of policies: Without question, the strategic review is an ambitious exercise, and while Lagarde has said that no stone will be left unturned, there are also fundamental points that we believe is key to ECB's monetary policy stance on reviving the euro area growth and inflation outlook that we do not expect ECB to address.

In order for ECB to have the best possible environment to lift inflation, the institutional setup in EU plays a critical role. While monetary policy and fiscal policies are independent (as they should be), coordination is essential to revive European growth and generating inflation. Here we find that the temporary Recovery and Resilience facility is a positive contribution, but without a permanent fiscal union, it will be difficult for ECB to completely achieve its primary objective. ECB are already at the limits of what monetary policy can do given that they can only operate on the supply of liquidity / funding conditions and not directly on the demand side of the economy. Outright transfers has been pushed back several times by ECB GC members.

The creation of the NGEU has also opened the door for the creation of a 'European safe asset'. A safe asset that ECB can use as a benchmark for conducting its monetary policy and also as part of a fiscal union would clearly help the ECB's ability to achieve its mandate. However, with the temporary nature of NGEU and the still 'limited' size of the issuance and liquidity we do not expect this to be sufficient to replace or even endanger the position of the German status as the European safe haven. In other words, NGEU is a welcoming first step, but not a sufficient initiative for ECB.

Output gap estimations: Another important question that ECB may touch on, but not provide conclusions on is how to measure and use the output gap in their forecasting exercise. As the output gap ultimately feeds into the ECB's staff projections it is an important variable for the tendency to overestimate the inflationary pressures in recent years.

Inflation estimations overshooting



Source: ECB, Macrobond and Danske Bank

Temporary inflation regimes: Inflation targeting regimes were established for the first time in the 1990's with the 2% level and significant changes to the economies have happened since then. These changes may both be temporary and longer-lasting (structural) and as such we do not believe that the possibility of adopting a temporary inflation regime should be ruled out. However, adopting a temporary inflation regime with a lower inflation objective, e.g. 1%, increases the risk of inflation expectations anchoring at these new low levels and therefore should only be used, if and only if, other policy areas would step up and over deliver compared to the recent measures. A clear rule-based stance should be used for when the returning to the 'structural' inflation regime should come in place again

Rating dependencies: The ECB's dependency on rating agencies has often been criticized. We expect ECB to gradually develop its own rating criteria, but this is a very large exercise that will take multiple years.

Will ECB now meet its inflation mandate?

A much asked question is whether the strategy review will alter its ability to reach the inflation target. As we neither expect ECB will develop new instruments that will make the achievement of the inflation target more probable, nor move the inflation objective closer to the current inflation rate objective, we do not see the probability of ECB meeting its inflation objective to be altered due to the strategic review.

This also means that ECB's credibility in its inflation projections and ability to reach the inflation aim, without the support of other policy areas, will not change without a further overhaul of the EU institutional setup. A clear explanation of the reasons for consistent inflation misses over the past decade would be a welcoming exercise.

We believe that if ECB would commit to unlimited QE and yield curve control based on a clear rule-based financing conditions method, the credibility of reaching the inflation target would increased. However, such a measure would definitely blur the lines between fiscal and monetary policy and may even infringe the Treaty, hence making the likelihood of such initiative low.

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Expected updates

None

Date of first publication

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