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Economic Synopsis
The ECB's monetary policy strategy: from the 2021 review to the 2025 assessment

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Abstract
The ECB is currently reassessing its monetary policy strategy and will announce its conclusions in 2025. This synopsis aims to contribute to the debate. It examines the significant changes in the macroeconomic environment since the 2021 strategy review and reflects on the lessons learned from recent experience with its key elements. The synopsis then raises four considerations relevant for the ongoing assessment: (i) When is a forceful or persistent monetary policy action needed? (ii) Is forward guidance a useful instrument? (iii) Should the long-run nominal anchor play a more explicit role? (iv) Should the strategy better reflect that economic activity and employment considerations may be taken into account in monetary policy decisions, provided that price stability is fulfilled? (JEL: E52, E58)

1. Introduction

The primary objective of the European Central Bank (ECB) is to maintain price stability. Without prejudice to this objective, the ECB shall support the general economic policies in the European Union in order to contribute to the achievement of its objectives. The ECB does not have the power to change its mandate[1],

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1. The mandate of the European System of Central Banks is laid down in Article 127 of the Treaty on the Functioning of the European Union.

but retains the autonomy to choose the monetary policy strategy to fulfil it. The strategy serves two main purposes. First, it provides policymakers with a coherent analytical framework that translates (actual or expected) economic developments into policy decisions. Second, it serves as a means of communicating monetary policy decisions to the public.

The outcome of the last review of the ECB's monetary policy strategy was announced in July 2021, almost two decades after the first review in 2003. The last review covered all aspects of monetary policy within the framework of the ECB's mandate and involved an extensive discussion within the Eurosystem (comprising the ECB and the euro area national central banks, including Banco de Portugal), organised into several workstreams, each focusing on a key topic.[2]

In the ECB's monetary policy strategy statement of July 2021, the Governing Council expressed its intention to assess periodically the appropriateness of the monetary policy strategy, with the next assessment expected in 2025. In July 2024, President Lagarde announced that an assessment would be presented in the second half of 2025 and clarified that this would not be a new strategy review, but rather an assessment of the previous review. Indeed, important elements of the 2021 strategy will not need to be reassessed (Lane 2024). In particular, the ECB will maintain the symmetric medium-term inflation target of 2%.

The 2025 assessment should begin with an examination of how effectively the current strategy has achieved its objectives, how economic conditions have evolved, and what insights can be drawn from recent advances in the economic literature. This synopsis aims to contribute to this examination and identifies four considerations that warrant a thorough discussion: (i) When is a forceful or persistent monetary policy action needed? (ii) Is forward guidance a useful instrument? (iii) Should the long-run nominal anchor play a more explicit role? (iv) Should the strategy better reflect that economic activity and employment considerations may be taken into account in monetary policy decisions, provided that the price stability objective is fulfilled? The synopsis does not have the ambition to provide a definitive answer to any of these questions. Nor does it propose any specific changes in the monetary policy strategy. Instead, it emphasises the need for an open and thorough discussion of these four considerations.

The first consideration highlights the need to discuss whether the strategy would be more robust if it stated that a forceful response to inflation deviations from target is required not only when policy rates are close to their effective lower bound (ELB)[3], as is currently stated, but also when inflation deviates upwards from target. Furthermore, it questions whether the current prescription of persistent measures at the ELB may have unintended consequences. Namely, if this prescription implies prolonged periods of low

2. Detailed results of these discussions were presented in 14 occasional papers that can be consulted at https://www.ecb.europa.eu/home/search/review/html/workstreams.en.html.

3. The ELB is the level beyond which the central bank is unable further cut the policy rate because a significant fraction of economic agents would be willing to switch from deposits to cash. The ELB considers the storage and security costs of holding physical cash.

interest rates, economic agents may perceive a change to a new long-run environment that may hinder the return of inflation to target.

The second consideration underlines the need to evaluate the usefulness of forward guidance. Initially introduced to provide additional accommodation when the policy rate was approaching the ELB, the ECB's experience has highlighted certain risks associated with its use. These include reduced flexibility to respond to rapidly changing economic conditions and the potential destabilisation of longer-term inflation expectations. A thorough discussion of the usefulness and design of forward guidance is thus essential.

The third consideration highlights the importance of understanding the level to which policy interest rates are expected to converge in the long run. It also discusses the potential benefits and challenges of communicating this level to the public. While there is substantial uncertainty around these estimates, providing some guidance on its level could help to anchor longer-term inflation expectations and enhance the clarity of policy decisions and their expected effects. A careful and detailed discussion of these issues is therefore crucial.

Finally, the fourth consideration emphasises the importance of discussing how the strategy could more clearly reflect the fact that monetary policy has a significant impact on economic activity and employment. It questions whether these effects could be taken into account in monetary policy decisions, provided that the primary price stability objective is fulfilled, as laid down in the Treaty on the Functioning of the European Union (TFEU). This recognition would need to be done cautiously to ensure that it is not interpreted in any way as a shift towards a dual mandate. However, it could prove valuable given the significant role that monetary policy can play in macroeconomic stabilisation, while also contributing to more consistent decision-making and communication.

The rest of the synopsis is structured as follows. Section 2 provides an overview of the context leading up to the 2021 strategy review and examines the profound changes in the macroeconomic environment since then. Section 3 reflects on the lessons learned from recent experience with the key elements introduced by the 2021 review. Section 4 raises four considerations for reflection in the ongoing assessment. Section 5 offers concluding remarks.

2. The evolving economic landscape

At the heart of the 2021 review was the need to reassess the ECB's strategy in the light of the prolonged environment of low inflation, low potential growth and low interest rates that characterised the euro area and other advanced economies in the aftermath of the global financial crisis.[4] Between 2009 and 2020, headline inflation in the euro area,

4. For a detailed discussion of the reasons for the 2021 ECB's monetary policy strategy review, see the Special issue "The European Central Bank's monetary policy strategy: reasons for a review" in the June 2020 Banco de Portugal Economic Bulletin.

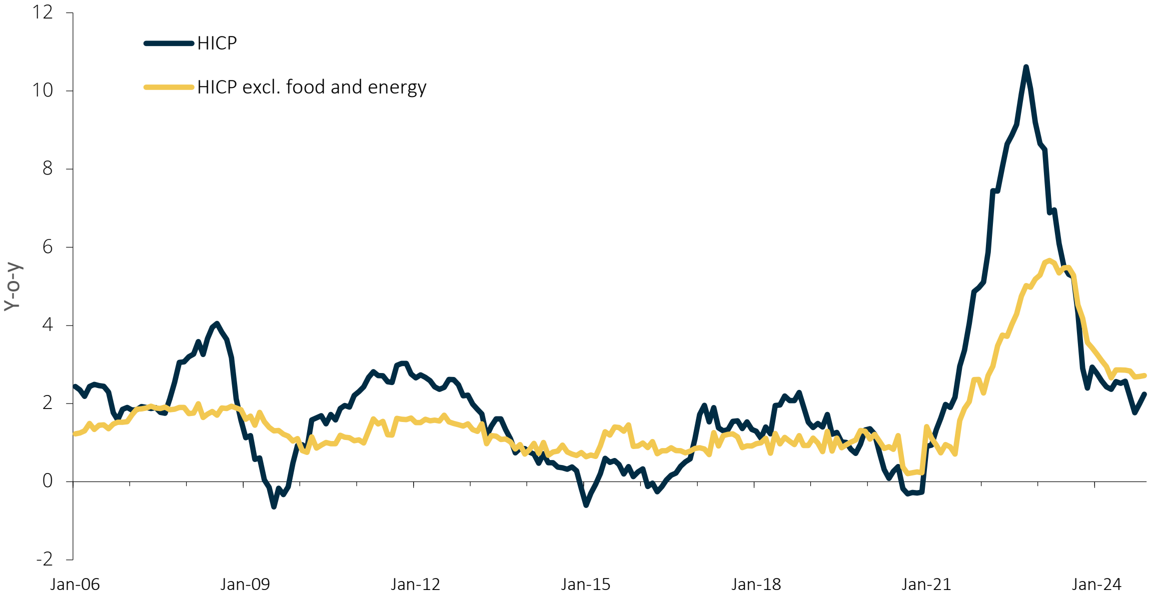

FIGURE 1: Inflation in the euro area

Note: Data up to November 2024.
Source: Eurostat.

measured as the year-on-year percentage change in the Harmonised Index of Consumer Prices (HICP), averaged 1.2% (Figure 1). This value was lower than the price stability objective, defined at the time as inflation below, but close to, 2% over the medium term. Year-on-year growth of HICP excluding food and energy (a measure of core inflation) averaged 1.1%.

Over that period, the natural interest rate likely continued a downward trajectory that had started in the 1980s. This interest rate is usually defined as the short-term real interest rate that is consistent with output being at its potential level and inflation being stable at the central bank's target in the absence of transitory shocks or nominal rigidities, i.e. in the long run. As discussed in Carvalho (2023) the decline in the natural rate was likely related to structural forces such as the decline in productivity and potential output growth, the ageing of the population and an increased demand for safe assets.[5] Relatedly, the nominal interest rate level at which the policy rate is neither contractionary nor expansionary, the neutral rate, also likely declined (Figure 2). This rate corresponds to the natural real rate plus the expected level of inflation, both in the long run.

In the prolonged period of low inflation and low natural interest rate, the key ECB interest rates were lowered to levels close to the ELB. When policy rates moved close to zero, limiting the space available to use this policy instrument, the ECB turned to unconventional monetary policy instruments to provide additional stimulus to bring

5. Additional information can be found in the Special issue "The natural interest rate: from the concept to the challenges to monetary policy" in the March 2019 Banco de Portugal Economic Bulletin.

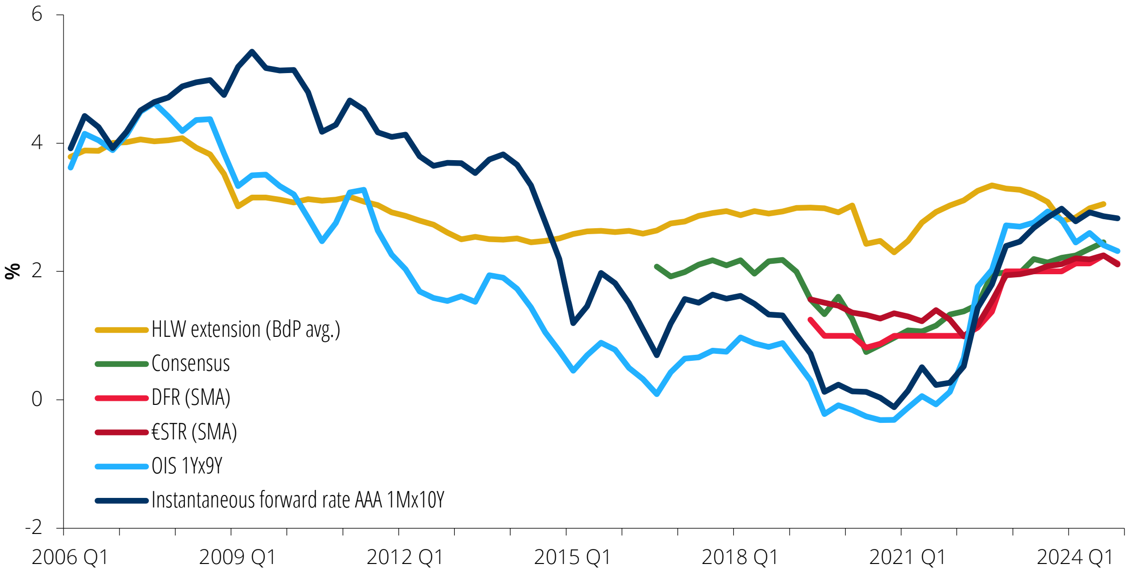

FIGURE 2: Estimates of the neutral interest rate in the euro area

Notes: The neutral interest rate can be defined as the natural real interest rate plus the expected level of inflation, both in the long run. Data up to 2024 Q3 in the case of HLW extension (BdP) and Consensus Economics and up to 2024 Q4 in the case of SMA (Survey of Monetary Analysts) and market data. HLW extension (BdP avg.): average of updated estimates based on Carvalho (2023). Consensus: estimates for the 3-month EURIBOR rate ten years ahead. SMA: estimates provided in the SMA for the level of the DFR (Deposit Facility Rate) and overnight rate in the long run; quarterly estimates consist of the average of the two surveys conducted on that quarter. Forward rates AAA: estimates for the 1-month rate ten years ahead based on AAA bonds. OIS: Overnight Index Swaps implied interest rates for 1-year, nine years ahead.
Sources: Consensus Economics, ECB, LSEG and authors' calculations

inflation back to the objective, including forward guidance, negative interest rates, longer-term refinancing operations and asset purchases. The size of the Eurosystem's balance sheet increased significantly (Figure 3).

While there is some evidence that the use of non-standard monetary policy measures had a positive impact on inflation (e.g. Rostagno *et al.* 2019), HICP growth remained below the objective and below most forecasts at the time. Longer-term inflation expectations started to drift downwards (Figure 4), raising concerns that they were less well anchored to the objective than in the past (e.g. Antunes 2015). In this context, some authors argued that, by continuously reinforcing the expectation that interest rates would remain low for an extended period, persistently low policy rates and the ECB's continued use of forward guidance may have led to a shift in expectations towards a "new normal" of low inflation and low interest rates, thereby contributing to the low inflation environment (e.g. Garcia and Teles 2016).

During this period, the financial and sovereign debt crises raised questions about the integrity of the euro area and highlighted the need to ensure the proper functioning of the monetary policy transmission mechanism in all jurisdictions. As a result, the ECB implemented measures to offset the emergence of non-fundamental interest rate spreads vis-à-vis risk-free benchmark rates across euro area jurisdictions that would impair the proper functioning of monetary policy transmission (Ayres *et al.* 2024). These

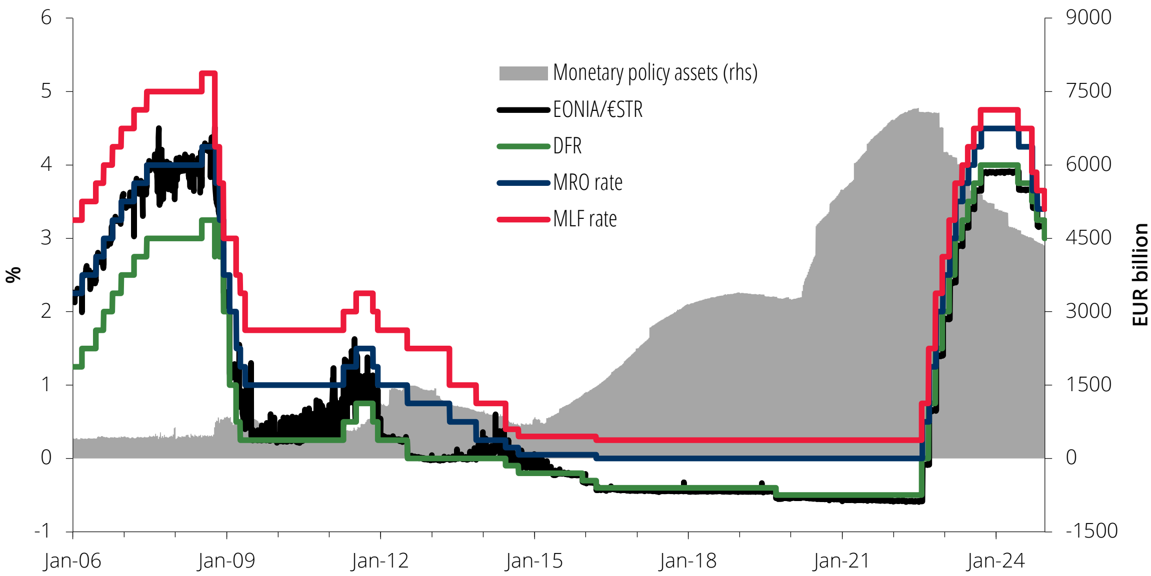

FIGURE 3: Eurosystem monetary policy assets, key ECB interest rates and euro area overnight market interest rate

Notes: Data up to December 2024. DFR – Deposit Facility rate, MRO – Main Refinancing Operations, MLF – Marginal Lending Facility. The overnight rate refers to the €STR from 2022 onwards and to the EONIA rate minus 8.5 basis points before that, in line with the approach proposed by the ECB. Monetary policy assets encompass purchase programmes as well as lending operations to euro area credit institutions.
Sources: ECB, LSEG and authors' calculations.

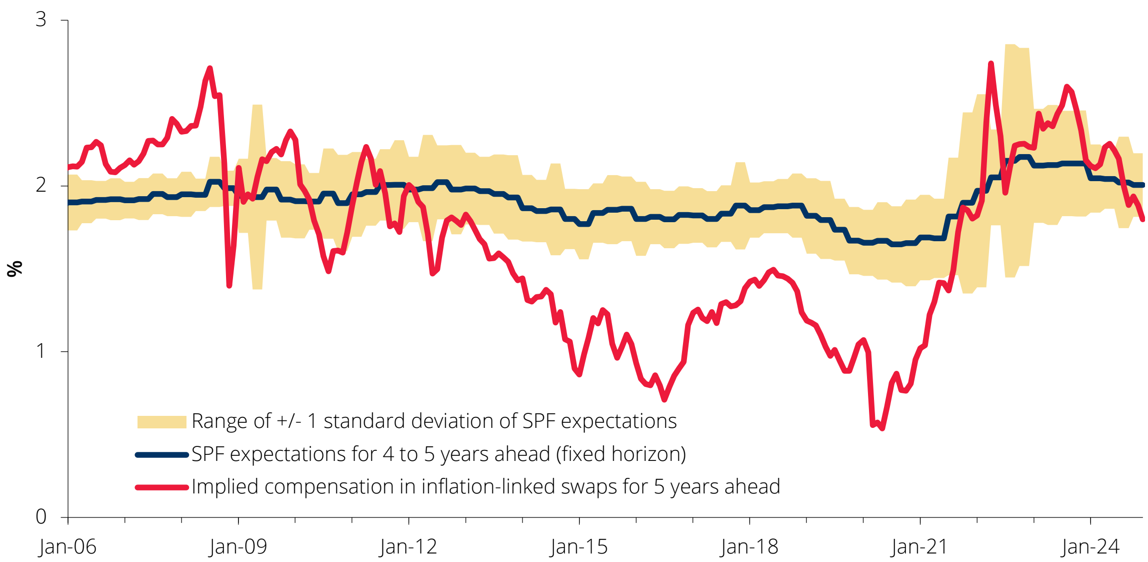

FIGURE 4: Longer-term inflation expectations in the euro area

Notes: Data up to December 2024 in the case of inflation swaps and up to 2024 Q4 in the case of the ECB's Survey of Professional Forecasters (SPF). Inflation swap data – monthly averages.
Sources: ECB, LSEG and authors' calculations.

measures included the Securities Markets Programme in 2010 and 2012, which involved the purchase of securities to address severe tensions in certain market segments. This programme was later terminated with the announcement of the Outright Monetary Transactions in 2012, a programme designed to safeguard an appropriate monetary policy transmission in all jurisdictions through the purchase of sovereign bonds with no ex ante quantitative limits but subject to strict conditionality.[6]

The year preceding the announcement of the 2021 monetary policy strategy was marked by the Covid-19 pandemic, a period of extreme uncertainty. The initial phase of the pandemic was characterised by a forced lockdown that disrupted normal consumption and production, with heterogeneous effects across sectors. The ECB launched a comprehensive package of complementary measures to ensure that all sectors of the economy could benefit from supportive financing conditions, including the Pandemic Emergency Purchase Programme, which played a dual role of providing additional monetary accommodation and, crucially, stabilising markets to guarantee the functioning of monetary policy transmission, through the flexibility it embedded (across time, asset classes and jurisdictions).

The economic landscape changed dramatically after mid-2021. Inflation rose sharply, peaking at 10.6% in October 2022, more than 5 percentage points above the previous maximum in the euro area history. The rise in inflation initially reflected the inability of supply chains to cope with the rapid recovery in global demand in the aftermath of the pandemic crisis.[7] The global nature of the shock also led to price increases abroad, which were transmitted to euro area prices via imports. The supply-demand mismatch led to heterogeneous cyclical conditions across sectors differently affected by the pandemic crisis and caused significant shifts in relative prices (Figure 5). These shifts were exacerbated by the constraints imposed by the start of the war in Ukraine, which also added to the uncertainty and posed significant challenges for monetary policy. As energy prices soared, Europe faced the risk of a deep energy crisis. Inflation spiked as the increase in energy costs spread throughout the economy, adding to the prevailing inflationary pressures. Core HICP inflation also rose as inflationary pressures became more broad-based.

In response to rising inflation, the ECB accelerated the tapering of net asset purchases, abandoned the use of forward guidance, and embarked on a rapid and unprecedented increase in its key policy rates to historically high levels. Notably, the Deposit Facility rate (DFR) was raised by 450 basis points in 14 months.

If there was considerable evidence of a decline in the natural rate at the time of the 2021 strategy review, the evidence for the more recent period is mixed. While some of the structural factors that contributed to low natural interest rates before the pandemic may still be at work, other factors may be exerting an upward pressure (Figure 2). For

6. Over this period, progress was also made in some dimensions of the institutional set-up of the euro area, with changes aimed at deepening the Economic and Monetary Union including the creation of the European Stability Mechanism and the establishment of the Banking Union.

7. For a detailed analysis on the influence of supply and demand factors on inflation in the euro area see, for example, Arce *et al.* (2024).

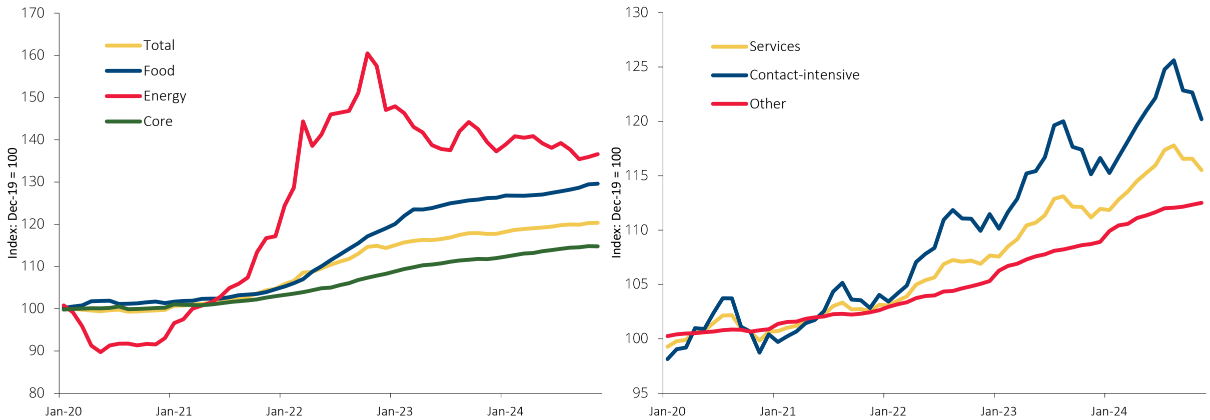

FIGURE 5: Euro area HICP main aggregates and services HICP

Notes: Data up to November 2024. Core – HICP excluding food and energy. Left-hand side – working day and seasonally adjusted figures (except for energy). Right-hand side – non-seasonally adjusted figures; contact-intensive services as identified in Lane (2022).
Sources: Eurostat, ECB and authors' calculations.

example, the substantial increase in public debt after the pandemic may put upward pressure on the natural rate (Benigno *et al.* 2024).

The rapid change in the economic landscape provides a valuable opportunity to assess the robustness of the strategy in a very different context from that for which it was designed. Insights from economic research and from the experience of recent years should be used to refine the strategy.

3. The 2021 strategy review: lessons from recent experience

The ECB's 2021 monetary policy strategy is expressed in two main documents: "The ECB's monetary policy strategy statement",[8] a 12-paragraph statement outlining the main features of the revised strategy and "An overview of the ECB's monetary policy strategy",[9] which expands on the reflection that underpins the strategy.

Key changes introduced in the 2021 strategy include: (i) a symmetric inflation target at 2%; (ii) the consideration of the implications of the ELB; (iii) a stronger emphasis on the medium-term orientation; and (iv) the recognition of financial stability as a precondition for price stability.[10] In this section, we reflect on the lessons learned from the recent experience with these elements.

8. See the strategy statement at www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_statement.en.html.

9. See the overview note at www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_overview.en.html.

10. The strategy review also included a dedicated action plan to integrate climate change considerations, as well as a commitment to improve communication in order to better engage with the public. See Duarte *et al.* (2024) for an overview of central bank communication initiatives in recent years.

3.1. *A symmetric inflation target at 2%*

The 2021 review changed the formulation of the price stability objective from inflation below, but close to, 2% over the medium term, to 2% inflation over the medium term.[11] The Governing Council also clarified that the commitment to the target is symmetric, i.e. deviations to the downside or to the upside are considered equally undesirable.

The change to a symmetric inflation target of 2% reflected concerns about a possible downward de-anchoring of inflation expectations. In part, this may have been related to the perception that the ECB was more tolerant to low inflation than high inflation, given that the previous definition established a ceiling rather than a clear target. By explicitly adopting a symmetric inflation target, the ECB intended to remove any perception of a higher tolerance for inflation outcomes below 2% and to reinforce the expectation of policy action in such scenarios. In addition, the focal inflation target of 2% is easier to communicate and reinforces the importance of a positive inflation buffer to provide room for manoeuvre for the policy interest rate, especially in the face of a lower natural interest rate, which could lead to the ELB being reached more frequently.

There is some evidence of the impact on inflation expectations of professional analysts of the change in the inflation target. According to the ECB's Survey of Professional Forecasters (SPF), in particular the special survey on the ECB's new monetary policy strategy conducted together with the survey for the fourth quarter of 2021, respondents identified the clearer 2% and symmetric inflation target as more understandable for the general public, and over one third of respondents revised their longer-term inflation expectations upwards as a result of the new monetary policy strategy (Meyler *et al.* 2021). In fact, the distribution of longer-term inflation expectations shifted to the right between the surveys for the second and the fourth quarters of 2021 (Figure 6). Nevertheless, it remains difficult to isolate the causal impact of the strategy review, as this shift over two consecutive surveys (i.e. two quarters) could be due to the sensitivity of longer-term expectations to higher inflation outcomes, as inflation was starting to rise at the time. Baumann *et al.* (2022), using the Survey of Monetary Analysts (SMA), which is available at a higher frequency (about 6 weeks), also document that there was a noticeable increase in the percentage of respondents expecting longer-term inflation at 2%, along with a decline in the percentage of respondents expecting inflation to be below 2%.

In the case of consumers, the impact of the 2021 strategy review on inflation expectations is less clear. In fact, a significant part of consumers has a limited knowledge of monetary policy and are difficult for central banks to reach.[12] For example, Hoffmann *et al.* (2023), using a randomised information provision experiment embedded in the Bundesbank Online Panel Households, report that German households made little

11. The 2021 review confirmed the HICP as the appropriate index for quantifying the price stability objective for the euro area.

12. Gomes *et al.* (2024) provide an analysis of the evolution of inflation expectations among euro area consumers in recent years. D'Acunto *et al.* (2024) present an overview of recent research on households' inflation expectations.

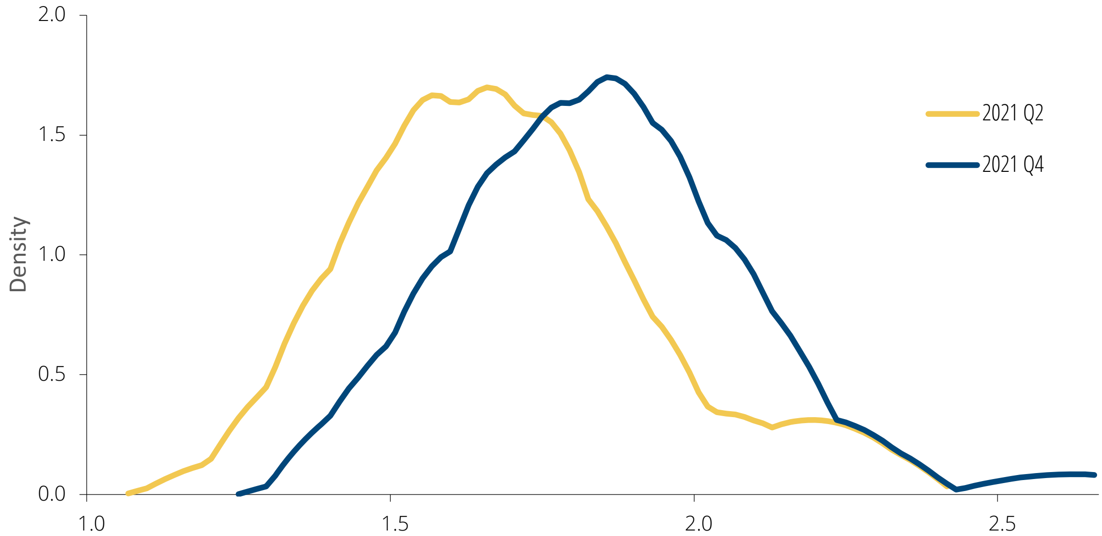

FIGURE 6: Longer-term inflation expectations for the euro area from the ECB's SPF

Notes: Distribution of point inflation expectations across individual forecasters. Longer-term expectations – 4/5 years-ahead. The sample was trimmed to exclude outliers (smallest and largest observation in each survey).
Sources: ECB and authors' calculations.

distinction between the previous and the current formulation of the inflation target. Galati *et al.* (2022), using a randomised control trial within a monthly Dutch household survey on short- and long-term inflation expectations, find that the ECB strategy revision did not have a material impact on household inflation expectations, but the high realisations of actual inflation did. Ehrmann *et al.* (2023), using specific questions added to the ECB's Consumer Expectations Survey, show that the 2021 announcement of the ECB's strategy review and the revision of its inflation target went largely unnoticed by the general public.

As for expectations of firms, the evidence is scarcer. Based on the Bank of Italy's Survey on Inflation and Growth Expectations, Bottone *et al.* (2022) show that although few firms paid attention to the new inflation target, those that did experienced reduced difficulty in interpreting it and adjusted their expectations closer to 2%.

The adoption of a symmetric inflation target at 2% may also have affected the evolution of the natural interest rate. Fernandez-Villaverde *et al.* (2024) suggest that part of the possible recent increase in the natural rates in both the euro area and the United States may be attributed to the monetary policy strategy reviews of the Federal Reserve and the ECB in 2020 and 2021, respectively. In the euro area, the authors argue that the revised inflation target formulation, by contributing to higher longer-term inflation expectations, may have led to a lower perceived probability of hitting the ELB and thus to a lower precautionary demand for safe assets, thereby contributing to a higher natural rate. Note that a higher natural interest rate, related to a lower perceived likelihood of hitting the lower bound, implies more monetary policy space for central banks to implement monetary easing through interest rate policy.

3.2. *Implications of the effective lower bound*

The 2021 strategy introduced an explicit reference to how monetary policy should be conducted in the vicinity of the ELB, which is an evident consequence of the low inflation/ low interest rate period that preceded the monetary policy strategy review. On the one hand, the revised strategy states that, close to the ELB, monetary policy must be particularly forceful or persistent to prevent negative deviations from the inflation target from becoming entrenched in inflation expectations. This may imply a transitory period in which inflation is moderately above target. On the other hand, the strategy emphasises that, while the primary monetary policy instrument is the set of key ECB interest rates, the instruments used by the ECB in the past when policy rates were close to the ELB will be used in the future. These instruments include forward guidance, asset purchases and longer-term refinancing operations.

A direct consequence of the 2021 strategy review was the revised forward guidance on interest rates announced by the Governing Council in the following monetary policy meeting, on 22 July 2021:

"(...) the Governing Council expects the key ECB interest rates to remain at their present or lower levels until we see inflation reaching two per cent well ahead of the end of our projection horizon and durably for the rest of the projection horizon, and we judge that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term. This may also imply a transitory period in which inflation is moderately above target."

In addition, at the time, the forward guidance on net asset purchases under the Asset Purchase Programme pointed to their continuation for a long period. It also remained linked to the guidance on policy rates, specifically stating that those net purchases would end shortly before the first increase in policy rates. Thus, the forward guidance on both policy rates and net asset purchases reinforced the idea that rates would remain unchanged for a prolonged period.

The economic developments that followed put into question the usefulness of intricate formulations of forward guidance, that are tied closely to specific macroeconomic developments and imply strong commitments for the future. In fact, the economic landscape changed rapidly and significantly, namely with the reopening from the pandemic crisis and the Russian invasion of Ukraine. Some authors have argued that the forward guidance formulation prevailing at that time may have delayed the monetary policy response at the beginning of the inflation surge (e.g. Orphanides 2023). This raises the question of how forward guidance should be formulated to ensure that monetary policy remains able to respond to changing economic conditions.

3.3. *Stronger emphasis on the medium-term orientation*

Since the first announcement of the monetary policy strategy, in 1998, the Governing Council has clarified that the price stability objective is to be achieved over the medium term. This reflected the need for a forward-looking perspective and the recognition of the existence of short-term price volatility, which cannot be completely controlled by monetary policy.

In the 2021 review, the Governing Council confirmed and strengthened the role of the medium-term orientation. In addition to recognising the inevitability of short-term deviations in inflation and the lags and uncertainties in the transmission of monetary policy, the monetary policy strategy statement explicitly states that *"the appropriate monetary policy response to a deviation of inflation from target is context-specific and depends on the origin, magnitude and persistence of the deviation"*. And it acknowledges that the medium-term orientation allows the Governing Council to take into account other considerations relevant for price stability in its monetary policy decisions. In the overview note that explains the monetary policy strategy in more detail, the ECB clarifies that the medium-term orientation *"provides the policy flexibility to assess the origin of the shocks and look through temporary shocks that may dissipate of their own accord, thus avoiding unnecessary volatility in activity and employment"*. Temporary supply shocks, which create a trade-off between inflation and real economic activity, are a case in point.

The medium-term orientation was instrumental in shaping the response to the inflation spike in 2021-2022. As mentioned in section 2, the initial increase in inflation was largely attributed to supply disruptions following the pandemic, although positive demand dynamics also played a role. These were expected to unwind over the medium term and thus immediate policy action was therefore not considered warranted. At the same time, this episode was also characterised by significant adjustments in relative prices and sectoral reallocations, for which monetary policy is not well-suited to deal with. By "looking through" these shocks for some time, monetary policy was proportional,[13] avoiding a larger negative impact on economic activity from a quicker monetary policy response. However, the situation changed. By the end of 2021, inflationary pressures were building up and became more pronounced as of February 2022, when Russia invaded Ukraine. The subsequent increase in energy and food prices led to a sharp rise in inflation to unprecedented levels and in a more persistent manner than expected, which could disturb longer-term inflation expectations. In response, the ECB rapidly raised policy rates and began to normalise the size of its balance sheet.

3.4. Recognition of financial stability as a precondition for price stability

The 2021 strategy emphasises the importance of monitoring the monetary policy transmission mechanism and recognises that financial stability is a precondition for price stability. This was an important breakthrough in the 2021 review. The strategy now acknowledges that the success in achieving the price stability objective depends on a well-functioning monetary policy transmission mechanism. Thus, when conducting

13. According to the overview note of the ECB's monetary policy strategy, the Governing Council systematically assesses the proportionality of its monetary policy measures when taking monetary policy decisions. This assessment includes an analysis of the benefits and possible side effects (i.e. unintended effects on the real economy and the financial system) of monetary policy.

monetary policy, the ECB may need to take decisions aimed at maintaining the singleness of monetary policy. This results from the lessons learned from the global financial, sovereign debt and pandemic crises.

The recognition that financial stability is a prerequisite for price stability was arguably a key factor in the creation of a new instrument, the Transmission Protection Instrument (TPI), in July 2022. The TPI was designed to ensure a consistent transmission of monetary policy across all euro area countries. It allows the Eurosystem to make secondary market purchases of government debt issued in countries where financing conditions deteriorate to an extent not justified by fundamentals, provided that the countries meet the criteria to ensure the pursuit of sustainable fiscal and macroeconomic policies. With this new instrument, the Governing Council underlined its commitment to the singleness of monetary policy in the euro area, as a prerequisite for the fulfilment of its price stability mandate. This new instrument also allows for a clearer separation between the objective of stabilising the financial system and the monetary policy stance.

The precise impact of the TPI on monetary policy transmission is difficult to assess empirically, especially as the programme has never been activated. However, the ECB's ability to implement a rapid sequence of interest rate hikes without causing financial market distress arguably provides indirect evidence of the usefulness of this instrument. Indeed, research suggests that, in a theoretical model, a programme such as the TPI can effectively eliminate the so-called "doom loop" between sovereigns and banks, thereby potentially mitigating distortions in the transmission mechanism (Rojas and Thaler 2024).

4. Consideration for the 2025 monetary policy strategy assessment

A strategy provides the basis for central banks' actions in the systematic pursuit of their mandates. In this sense, the actions of most central banks are to some extent predictable, as they operate within what can be described as a targeting framework (Svensson 1999), even if no central bank follows a mechanical rule for setting the policy instrument, like the well-known Taylor rule (Taylor 1993). Nevertheless, there are times when monetary policy decisions deviate from the "usual" way of setting the policy instrument towards more flexible approaches, namely when faced with large shocks or shocks of an unusual nature. The inflation surge in 2021/2022 was an example of this. Still, central banks, including the ECB, are always bound by their mandates, which are embodied in their strategies, and which then frame their actions.

In order to fulfil its purpose, a monetary policy strategy should be based on the best understanding of how monetary policy works. Most central banks believe that, when inflation deviates, or threatens to deviate, to the downside, central banks should temporarily lower nominal interest rates to keep inflation at target. This will induce a fall in the real interest rate, which in turn temporarily stimulates aggregate demand and ultimately inflation (and vice versa if inflation rises). By reacting in this way, central banks hope to avoid large deviations of inflation from target, thus contributing to maintain inflation expectations well anchored to the price stability objective.

At the same time, if central banks move interest rates permanently the effect may be different, as advocated in a recently revived literature (Valle e Azevedo *et al.* 2022, Uribe 2022). For example, if a central bank cuts interest rates permanently, agents adjust their expectations to a "new normal" with lower interest rates, and inflation will eventually fall in proportion to the decline in interest rates. Thus, a very persistent decline in the policy rate may lead to a decline in inflation, in contrast with the positive impact of a temporary decline in interest rates. This is a possible explanation for the long period of low policy rates and low inflation in Japan over the past two and a half decades (Jones *et al.* 2024). Likewise, one possible justification for the persistently low inflation in the euro area in the pre-pandemic period is arguably that agents perceived the low policy rates as a "new normal", which may have been reinforced by the use of forward guidance.

Finally, to serve its purpose effectively, the ECB's monetary policy strategy needs to be robust under different economic conditions. For example, it should provide a flexible framework for policy decisions both in periods of low and high inflation, while considering the complexities and challenges posed by sudden shifts in the economic environment, such as those of recent years.

Bearing all these aspects in mind, the 2025 assessment of the ECB's monetary policy strategy is a good opportunity to reassess some of the elements of the current strategy. Four relevant considerations are discussed below. This discussion does not have the ambition to provide a definitive answer as to whether and how these should be incorporated in the 2025 strategy. Instead, it highlights why they warrant a comprehensive debate.

Consideration 1: When is a forceful or persistent monetary policy action needed?

As detailed in section 3.2, the 2021 strategy introduced explicit references to how monetary policy should be conducted in the vicinity of the ELB. First, the strategy expresses the need for different instruments. Second, the strategy states that monetary policy must be particularly forceful or persistent to prevent negative deviations from the inflation target from becoming entrenched in inflation expectations.

The recognition of the need for different instruments at the ELB is important, as the ELB hampers the use of the main policy instrument (interest rates). Although the commitment to the target is symmetric, there is an asymmetry in the reaction of policy rates associated with the ELB, calling for the use of different instruments.

The prescription of forceful measures when inflation deviates downwards from target is also important, as those measures may contribute to maintain inflation expectations well anchored and reduce the probability of reaching the ELB. However, a forceful response when inflation deviates upwards from target may be equally important to maintain inflation expectations well anchored. Thus, prescribing forceful measures only for downward deviations from the target, without an equivalent prescription for upward deviations, may work against the symmetry of the target.

The prescription of persistent monetary policy measures near the ELB raises additional concerns. If the interpretation above regarding the effects of persistent, possibly permanent, policy measures is correct, then under the current strategy and in the absence of the significant shocks that occurred since 2020, the euro area could potentially have remained in a regime of low interest rates and below-target inflation. Correspondingly, persistent measures in a high inflation environment,[14] if maintained for too long, could end up contributing to destabilise longer-term inflation expectations on the upside and thus prevent a sustained decline in inflation towards the target.

Against this backdrop, a thorough discussion of when a forceful or persistent policy response is needed. The strategy may be more robust if it states the need for effective policy action when there is a risk of longer-term inflation expectations being destabilised, either to the upside or the downside. Moreover, the usefulness of particularly persistent measures at the ELB to bring inflation back to target should be assessed, given the possibility of destabilising longer-term inflation expectations.

Consideration 2: Is forward guidance a useful instrument?

During the period of low inflation and low interest rates, the ECB made extensive use of forward guidance, committing itself to keeping interest rates low for an extended period. The formulation of the forward guidance evolved significantly over time. In July 2013, the Governing Council expressed its expectation that interest rates would remain low *"for an extended period"*. Over time, the forward guidance became more specific, incorporating date-based or state-based criteria. For example, in June 2018, the Governing Council expressed that it expected rates to remain steady *"at least through the summer of 2019 and in any case for as long as necessary to ensure that the evolution of inflation remains aligned with our current expectations of a sustained adjustment path"*. By September 2019, the Governing Council stated that it expected rates to remain low *"until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics"*. As explained in section 3.2, the formulation adopted after the strategy review was intricate, linked to specific economic developments, and included the admission that a period of inflation moderately above target could be suitable.

Forward guidance was introduced with the goal of providing additional accommodation when the policy rate was approaching the ELB, thereby contributing to achieve the desired monetary policy stance. The aim was to influence agents' interest rate expectations at long horizons, influencing spending and investment decisions and ultimately inflation, in a situation when the regular use of the main policy instrument was hampered.

However, the use of forward guidance carries risks. It can significantly reduce the flexibility of the central bank to adjust the policy stance in response to sudden shifts in economic conditions and could potentially destabilise longer-term inflation

14. In the recent cycle, when policy rates reached their peak, the Governing Council communicated that the key ECB interest rates were at levels that, "maintained for a sufficiently long duration", would make a substantial contribution to the timely return of inflation to the target.

expectations. These risks are present across various formulations of forward guidance, albeit to differing extents. Date-based forward guidance may be clearer to communicate to a wider audience but reduces flexibility to respond to changing economic conditions and if announced for a long period may convey the perception of a "new normal". State-based formulations may allow for the flexibility that is needed to adjust the stance of policy in case circumstances change rapidly. However, if state-based forward guidance is set against very specific inflation objectives, it may imply a commitment to keep interest rates unchanged for a very long time if the pre-specified objectives are not met. Again, this can potentially de-anchor longer-term inflation expectations.

The ECB's experience with the use of forward guidance in recent years suggests the need of a thorough discussion of its usefulness as a policy instrument, namely given its heavy reliance on the management of expectations at long horizons. In case it is seen as useful, namely in combination with other policy tools, its design needs to be carefully pondered to avoid destabilising inflation expectations and allow the necessary flexibility to deal with changing economic conditions.

Consideration 3: Should the long-run nominal anchor play a more explicit role?

When inflation (or the inflation outlook) deviates from the target, central banks typically adjust their monetary policy instruments, namely the policy rates, to help bring inflation to target and, importantly, to avoid destabilising longer-term inflation expectations. In fact, anchored inflation expectations, in particular in the longer run, are the image of the central bank's success in fulfilling its price stability mandate.

Central banks should be committed to ensuring consistency with their long-term nominal anchor, the inflation target. In the long run, the nominal policy rate should converge to a neutral level, which is given by the natural real interest rate plus the central bank's inflation objective, 2% in the case of the ECB. Monetary policy affects real interest rates in the short run, but in the long run the natural real interest rate is assumed to be broadly independent of the actions of the monetary authority. To be consistent with the central bank's objective, policy rates should follow the fundamental forces driving the economy in the long run.

As the policy rate should to converge to its neutral level in the long run, communicating an estimate of the neutral policy rate, or a range of estimates, may provide a useful anchor for other economic agents. There are at least three main difficulties in communicating the level of the neutral policy rate: (i) the natural interest rate has to be estimated because it is unobservable, (ii) there is high uncertainty in these estimates because they are highly model and horizon dependent, and (iii) the estimates tend to be revised substantially over time. Given such difficulties, communicating the neutral rate could hinder central bank's credibility.

However, the introduction of this nominal anchor in communication could have several benefits. It could help to clarify the monetary policy stance (deviations of the actual policy rate from the neutral rate), support well-anchored inflation expectations by providing a long-term anchor for the policy rate consistent with the inflation target, and facilitate the explanation of the expected effects of policy decisions. This would contribute to the strategy's objective of providing a comprehensive framework for taking policy decisions and communicating them to the public. The practice of other central banks around the world, such as the US Federal Reserve, the Bank of Canada, or the Reserve Bank of New Zealand, which regularly publish an estimate or range of estimates for the neutral interest rate, suggests that the benefits of communicating the neutral rate may more than offset the aforementioned challenges.

The current reassessment of the ECB's monetary policy strategy should therefore consider thoroughly reassessing the level and drivers of the natural interest rate, and consequently the neutral rate, in order to better inform policy decisions. Also, the benefits and costs of tracking and eventually communicating the neutral level of (nominal) policy rates and, relatedly, the level of the (real) natural interest rate should be assessed.

Consideration 4: Should the strategy better reflect that economic activity and employment considerations may be taken into account in monetary policy decisions, provided price stability is fulfilled?

The TFEU states that, without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Union with a view to contributing to the achievement of its objectives. These objectives, which are set out in Article 3 of the Treaty on European Union, include, among others, balanced economic growth and a highly competitive social market economy aiming at full employment and social progress.

In line with this, the 2021 strategy specifies that, without prejudice to price stability, in its monetary policy decisions the Governing Council caters for other considerations relevant to the conduct of monetary policy. The overview note elaborates: *"Taking such considerations into account will often be necessary to maintain price stability over the medium term. At the same time, monetary policy measures have an impact on the economy and on economic policies."*

The formulation in the strategy seems to imply that economic activity and employment considerations will be taken into account, but only to the extent necessary to maintain price stability. However, and in line with the TFEU, economic activity and employment could be considered independently, provided that the price stability mandate is fulfilled. In fact, when different policy options exist that are compatible with fulfilling the mandate, the fact that different policy choices have different economic costs is necessarily considered. A better reflection of this in the strategy would make it more consistent with the TFEU, provide scope for more coherent monetary policy decisions and for simpler communication of decisions to the public. Moreover, as monetary policy can play an important role in macroeconomic stabilisation, this recognition could prove valuable.

However, there are certainly concerns associated with such recognition. First, it should not be interpreted as a move towards a dual mandate. Moreover, there is a risk that this flexibility is not applied symmetrically and is seen as justifying for an easing bias that could lead to higher inflation. To address these concerns, the strategy would need to reiterate that price stability is the primary objective, and make clear that economic activity and employment would only be considered insofar as they impact the inflation outlook or explicitly as a relevant consideration when the primary objective is fulfilled.

Against this background, the 2025 assessment provides an opportunity to discuss how the strategy could more clearly reflect that economic activity and employment considerations can be taken into account in monetary policy decisions, provided that this does not preclude the price stability objective.

5. Concluding remarks

In a dynamic and evolving environment, it is crucial to continuously draw on past experience and advances in economic knowledge to ensure the effective conduct of monetary policy. Regularly refining the ECB's strategy on the basis of these insights is key to navigating future challenges and maintaining price stability in the euro area. This principle was recognised in the ECB's 2021 monetary policy strategy, where the Governing Council reaffirmed its commitment to periodically assess the appropriateness of the strategy. While the 2021 strategy has generally provided valuable guidance to the ECB, it is important to take stock of the lessons learned over the past few years in order to further strengthen its effectiveness.

This synopsis reflects on lessons learned since 2021 and identifies four key considerations that are relevant for the 2025 assessment. The first consideration questions the role of forceful and persistent monetary policy measures close to the ELB, alerting that a decisive response to inflation deviations on both sides is important to stabilise inflation expectations, but that persistent measures may be destabilising. The second questions the usefulness of forward guidance, especially given that certain formulations risk disrupting long-term inflation expectations. The third discusses whether a more explicit role could be given to the long-run neutral level of the policy rate. Finally, the last consideration debates if there is room for economic activity and employment considerations to be taken into account in monetary policy decisions, provided that this does not preclude the price stability objective.

Preparatory work for the 2025 assessment has started within the Eurosystem. As explained in Lane (2024), the planned works for the 2025 strategy assessment will focus on two key strands: (i) economic developments since the 2021 review; and (ii) the implications for monetary policy. The first strand will examine the factors shaping the inflation and economic environment in light of the recent episode of high inflation, analyse the likely evolution of these factors over the coming years, and consider the implications for the future inflation environment. As part of this analysis, the assessment will also consider possible enhancements to the analytical toolkit, including forecasting techniques. The second strand will cover the implications of the changed inflation environment for the monetary policy strategy. This will include a review of the recent experience with the evolving policy instruments, an examination of the operationalisation of the medium-term orientation of the monetary policy strategy, and an analysis of how to better manage risk and uncertainty in policy setting and communication.

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