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**Research Report**

## ECB strategy review - The new pillars: Communication and climate change

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# IW-Kurzbericht 122/2020

## ECB Strategy Review - The New Pillars: Communication and Climate Change

Markus Demary / Michael Hüther, 9. Dezember 2020

**The European Central Bank (ECB) is reviewing its strategy. Key pillars are its communication and how monetary policy should address climate change. We advise the ECB to strengthen its communication especially with social groups unfamiliar with monetary policy. When it comes to climate change, the ECB should be responsive, but not activist.**

ECB-President Christine Lagarde has announced a comprehensive review of the monetary policy strategy. The last strategy review has taken place 17 years ago. The current review will include a survey of different social groups, like firms and households. In doing so, the ECB acknowledges that communication with a broader public beyond financial market specialists is important and that it has not properly addressed the public in the past. Monetary policy, as an "unelected power" (Paul Tucker) without democratic legitimation, must face up to public debate in a special way, so that its actions can be comprehended.

### Broadening the communication

Communication and accountability are key pillars of the inflation targeting framework which was originally proposed by Lars E. O. Svensson (Svensson, 2010). In this framework communication with the public is a policy

tool for managing inflation expectations, since expectations contribute to future inflation dynamics. This is reflected in the ECB's forward guidance, which aims at stabilizing inflation expectations by communicating the future path of monetary policy interest rates.

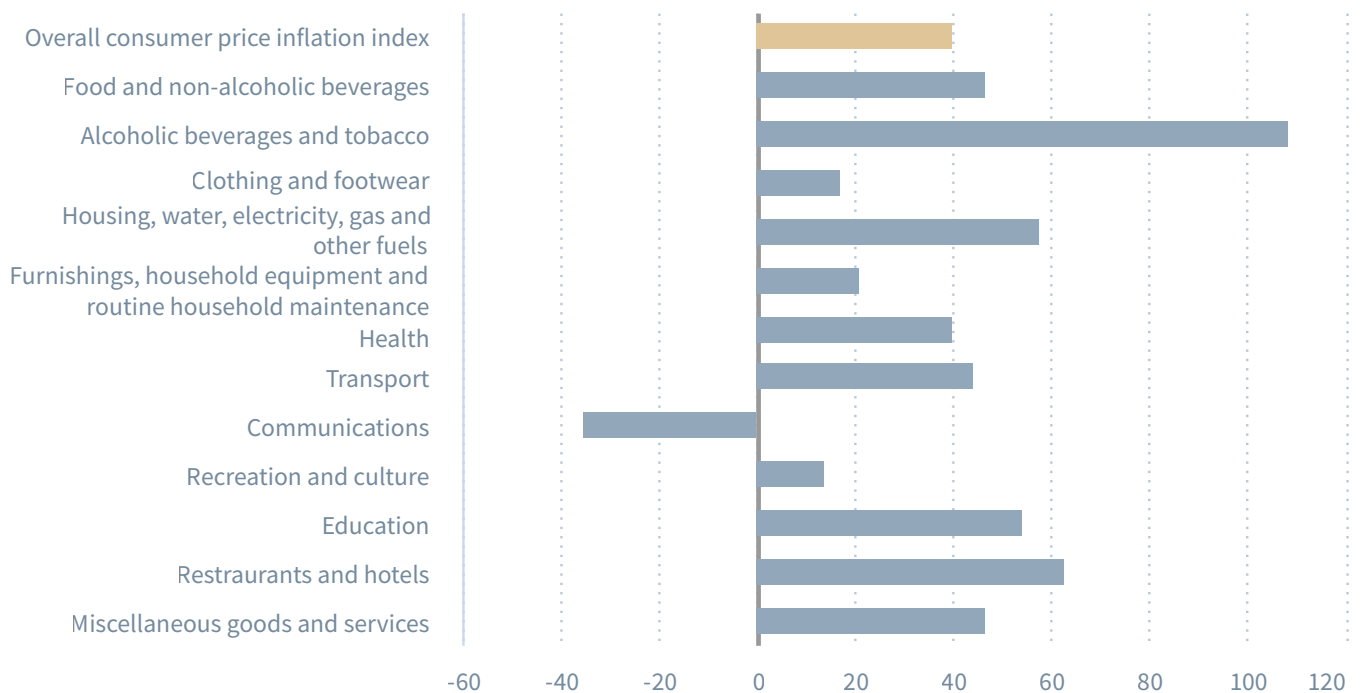
However, the ECB communication is often limited to communiques with the European Parliament, the European Commission and through press conferences and speeches to high-level audiences. It is therefore questionable whether this communication reaches the general public, including companies that set prices and wages. This starts with the technical language (PSPP, LTRO, TLTRO, Forward Guidance etc.), which is hardly understood outside the finance and research community. Moreover, the different social groups' inflation expectations differ a lot from financial market experts' forecasts, on which the ECB relies.

### The cost of living varies between social groups

That is because the costs of living of the different social groups differ from the development of the costs of living from the representative household, from which the consumer price index is calculated. Poorer households, for example, are more affected by price increases of rent

# Prices for goods and services developed differently

Percentage increase since January 2000



Source: Eurostat; own calculations

and food than richer households, because rent and food make up a larger part of their consumption basket. In addition to that, goods with decreasing prices, like telecommunication, make up a smaller part of their consumption basket compared to richer households. Studies for the US find, for example, that poorer households are much more affected by increases in gasoline prices and that older households are more affected by increases in health care expenditures (Hobijn/Lagakos, 2003).

The different consumption patterns contribute to the variation in subjective inflation expectations. Thus, households with a higher share of price-sensitive goods and services in their consumption basket will have a hard time in acknowledging that a 2 percent inflation target is in line with price stability, since they see their costs of living increase. Communicating the need for and the benefits of an accommodative monetary policy is especially important to these households because a lack of comprehensiveness lowers the acceptance of monetary policy. The acceptance and understanding of central bank decisions could be improved by including the ef-

fects of central bank decisions on employment into central bank communication (Wiebe, 2020). That is because households can observe that accommodative monetary policies lower their interest rate incomes, while they cannot observe how accommodative monetary policies stabilize their labor income.

While labor market policy or health policy is well understood by the population, the same is not true of monetary policy. One cause is that the population's financial education has not kept pace with developments in the financial industry. Therefore, financial market topics have to be taught on a much broader scale. Former US Federal Reserve President Alan Greenspan has used the media very heavily. He was known to a large part of the population through TV appearances, although he was often not understood. It would be desirable if more and continuous exchanges were sought from the ECB board members, especially in the popular media formats.

## Failure to meet the inflation target

The failure to meet the inflation target in many currency areas over the past decade reflects the fact that inflation targeting - unlike its introduction when it credibly reduced inflation rates in the industrialized countries - cannot credibly increase inflation rates if the banking system and companies are persistently stuck in a balance sheet recession. The 2 percent upper limit seems credible, but not the 2 percent point target.

The Fed switched to average inflation targeting after a prolonged period of low inflation rates, during which the price level increase was well and sustainably below the 2 percent inflation level. But the fact remains that managing inflation expectations does not work if only the financial market experts are consulted when measuring them while a large part of the population probably does not understand the technical details of inflation targeting. As a consequence, the strategy change to average inflation targeting could be interpreted as a justification for a longer period of expansionary monetary policy by the broader public.

## Monetary policy and sustainable finance

Appropriate public communication will be all the more difficult if monetary policy is overhauled with additional objectives. As important as the Green Deal is, monetary policy can make little contribution to its implementation. While the ECB may support the general economic policy, it must also be market-neutral. When buying securities, it is therefore already difficult to take climate neutrality into account. If  $x$  percent of the bond market consists of green bonds, the ECB can also buy  $x$  percent of its monetary policy securities in green bonds without violating market neutrality. This would no longer be the case if the ECB deviated from the  $x$  percent threshold in its monetary policy operations.

However, climate risks are becoming increasingly relevant for the financial sector. The rating agencies are taking climate risks into account in their ratings and, increasingly, rating downgrades due to weather risks are taking place instead. If climate risks cause the cre-

ditworthiness of companies to fall and thus credit risks to rise, the ECB must address this in its collateral framework.

In this way, the ECB is quite capable of accompanying the general trend towards sustainable finance; it must even do so in its role as supervisor (if, for example, credit risks from green projects are underestimated). Moreover, a change in investment behavior can influence the transmission process, which would be relevant for the ECB. But it can do so from an observing and reacting position. However, it is not the task of a central bank to support or slow down a structural change. That is the task of development banks.

## Literature

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