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**Working Paper**

## Improving the ECB's policy strategy

IMFS Working Paper Series, No. 220

**Provided in Cooperation with:**

Institute for Monetary and Financial Stability (IMFS), Goethe University Frankfurt am Main

*Suggested Citation:* Orphanides, Athanasios (2025) : Improving the ECB's policy strategy, IMFS Working Paper Series, No. 220, Goethe University Frankfurt, Institute for Monetary and Financial Stability (IMFS), Frankfurt a. M.

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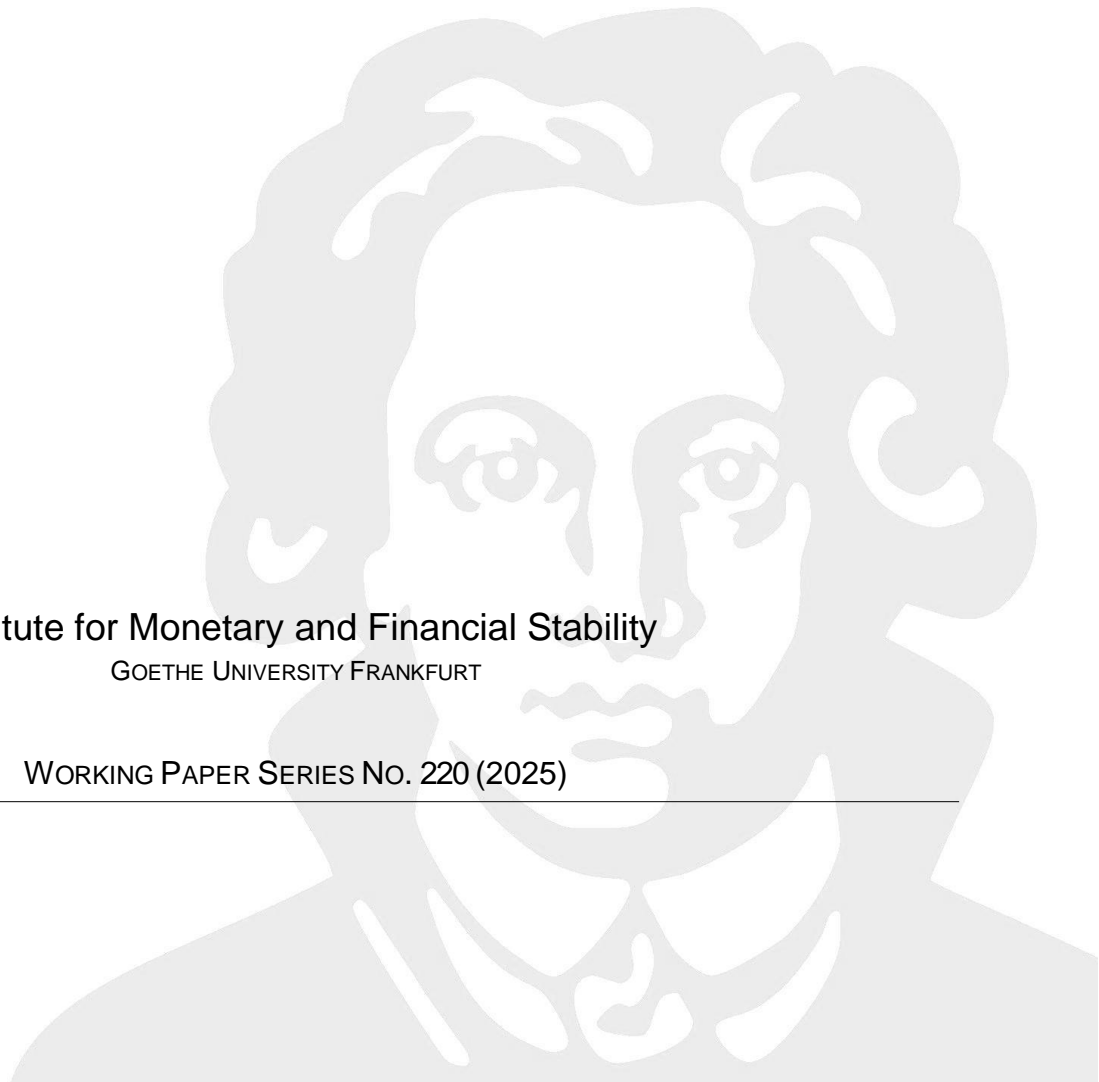
Athanasios Orphanides

## Improving the ECB's policy strategy

Institute for Monetary and Financial Stability  
GOETHE UNIVERSITY FRANKFURT

WORKING PAPER SERIES No. 220 (2025)

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# Improving the ECB's policy strategy

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June 2025

## Abstract

The ECB can fulfil its mandate better and contribute to a stronger Europe by adopting sensible rules instead of relying on discretionary decision-making. A simple rule for the policy rate can promote systematic monetary policy and protect against significant policy errors. Ending the reliance on credit rating agencies for determining the collateral eligibility of government debt can improve the functioning of government bond markets and lower financing costs for governments. With sensible rules, the ECB can secure price stability and avoid unwarranted fragility in government bond markets. Alleviating fiscal stress can free fiscal resources for public investment aimed at boosting productivity, greening the economy and strengthening European defense. Within its mandate, the ECB can serve Europe better than in the past.

Keywords: ECB, policy rules, forward guidance, fiscal stress, collateral framework.

JEL Classification: E52, E58, E61, H63.

\* This paper is based on the author's presentation at *The ECB and Its Watchers XXV*, Frankfurt, 12 March 2025.

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## **I. Introduction: Evaluating ECB policy strategy**

Europe currently faces a more precarious economic and geopolitical environment than it did five years ago, when the ECB's previous strategy review was underway. Improving the ECB's policy strategy is more important than ever. While the revised strategy, announced on 8 July 2021, was a step forward, the ECB left critical challenges unaddressed.

The focus of my discussion will be two such challenges that were not satisfactorily addressed by the ECB in its previous strategy review: Challenges with the price stability mandate; and the continuing fragility in government bond markets. A common theme underlying these issues is the ECB's proclivity for discretion over sensible rules. While discretionary policy may offer greater "flexibility" in decision-making and can appear attractive, it opens the door to deviations from core principles of sound central banking, thereby increasing the risk of preventable policy errors. For both challenges discussed here, such policy errors materialized within months of the adoption of the revised strategy in 2021.

The inflation spike of 2021-22 was the result of a policy error in the calibration of monetary policy. Relying on discretion, the ECB downplayed the consequences of maintaining monetary policy too accommodative for far too long. In the second half of 2021 and the first half of 2022, while inflation was rising above its definition of price stability, the ECB kept the policy rate negative and continued asset purchases, in contrast to what was suggested by sensible rules.

The turmoil in government bond markets observed in Spring and Summer 2022 reflected another avoidable policy error: The ECB's decision on 24 March 2022 to elevate the role of credit rating agencies in determining the collateral eligibility of government debt. With this decision, the ECB re-introduced unwarranted debt-roll-over risk in government bond markets, and signaled its preference for discretion over sensible rules to address the associated tensions.

The ECB can fulfil its mandate better and contribute to a stronger Europe by adopting sensible rules instead of relying on discretionary decision-making. A simple rule for the policy rate can promote systematic monetary policy and protect against significant policy errors. Ending the reliance on credit rating agencies for determining the collateral eligibility of government debt can improve the functioning of government bond markets and lower financing costs for governments. With sensible rules, the ECB can secure price stability and avoid unwarranted fragility in government bond markets. Alleviating fiscal stress can free fiscal resources for public investment aimed at boosting productivity, greening the economy and strengthening European defense. Within its mandate, the ECB can serve Europe better than in the past.

## II. Challenges with the price stability mandate

In line with recommendations made in 2020 (including at ECB Watchers XXI), on 8 July 2021 the ECB adopted a symmetric 2% inflation target.<sup>1</sup> This was a significant improvement for the ECB, albeit long overdue. The recommendation for the ECB to adopt a clear, symmetric 2% inflation target as the definition of price stability goes all the way back to the ECB's adoption of its original policy strategy in 1998 and was reiterated during the policy debate leading to the 2003 strategy revision. Back then, the ECB opted for a more ambiguous definition of price stability, a decision that posed unnecessary risks to effective policymaking. Until the Global Financial Crisis, this ambiguity did not cause obvious harm: The ECB was quite successful in maintaining inflation and inflation expectations close to 2%, and facilitating economic growth. But the ambiguity in the definition of price stability did subsequently lead to a serious policy error. This was manifested in what became known as the ECB's "lowflation" problem. Policy was overly restrictive for many years, unnecessarily depressing output and employment (Lengwiler and Orphanides, 2020).

Adoption of a symmetric 2% inflation target corrected this ambiguity. However, the ECB failed to adopt additional recommendations that would have promoted a more systematic and effective approach to achieving this target. Instead, the ECB favored a discretionary policy approach. In some respects, the ECB strategy could be characterized as flexible inflation targeting, but with a stronger emphasis on flexibility rather than on defending the inflation target. Policy appeared heavily influenced by model-based optimal control methods, an approach known to lack robustness. A basic premise in model-based optimal control exercises is that as long as inflation expectations are assumed to be anchored at 2%, inflation will always revert to 2% within 2, 3, 4 years, inviting policy to be "flexible." The result is a propensity to accommodate discretionary considerations and downplay deviations of inflation from target that are perceived to be temporary. In the model, this works. In practice it does not.

The failure to adopt recommendations promoting systematic decision-making proved consequential. Unhelpful discretion led to a policy error almost as soon as the ECB adopted its revised strategy in July 2021. The ECB fell into the forward guidance trap: It kept the policy rate unchanged while inflation was rising above 2%, pushing real interest rates to record negative levels, thereby fueling inflation (Orphanides, 2024).

The ECB's policy error in this episode can be easily seen by comparing the evolution of inflation, and interest rates. Figure 1 compares the one-year inflation swap rate, a market-based, forward-looking measure of inflation, with two nominal interest rates: the overnight policy rate, and the one-year overnight-index-swap (OIS) rate, which captures forward guidance about the policy rate. The inflation swap rate was effectively on target, 2%, when the ECB adopted its new strategy in July of 2021. It had been rising from below 2% and kept

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<sup>1</sup> The proceedings of the 2020 meeting of the ECB and its Watchers (ECB Watchers XXI), provide a record of the discussion (Wieland, 2020).

rising above 2% throughout the rest of 2021. Despite inflation moving further away from the ECB's 2% goal, there was no corresponding policy action, no policy response.

While the policy easing that was implemented with asset purchases was essential at the beginning of the pandemic, it was no longer appropriate by the end of 2021. Yet, the ECB not only continued asset purchases into 2022, but also communicated it would keep the policy rates negative until after it stopped these purchases. Once war returned to Europe in 2022, the situation worsened even more. The start of the war led to a rapid increase in inflation in Spring 2022. And yet, the ECB policy rate stayed unchanged at a negative level until July 2022. Failing to adjust the nominal policy rate under these circumstances was an elementary policy mistake.

Why is this important? Because what really matters for the economy is the *real* interest rate. By keeping the nominal rate pegged at the same level for too long, while inflation deviated further and further away from the inflation target, the ECB created a destabilizing situation, one of the two basic errors described in Milton Friedman's 1967 presidential address. The error is evident in Figure 2 where the one-year nominal rate in Figure 1 is replaced with the corresponding ex ante real interest rate. By keeping the nominal rate unchanged, and communicating that it would keep it low, the ECB kept pushing the *real* interest rate down while inflation was rising. The ECB fell into the forward guidance trap.

To be sure, the inflation spike observed in 2022 was not solely the result of ECB policy errors. We must recognize the role of the war, a very ugly shock that would have resulted in some inflation even with good policy. But it's one thing to have ugly shocks that create an inflationary problem and another thing to fuel inflation further by using discretion to support inappropriately calibrated policy.

The ECB can and must do better. Solutions are available in the form of simple and robust policy rules. ECB policy can be more systematic and successful with guidance from a benchmark policy rule. This is not a novel idea, recommendations along these lines had been made in the past, including at earlier meetings of the ECB and its Watchers. Instead of relying on meeting-by-meeting discretion, the ECB can communicate the systematic nature of its policy with a benchmark policy rule. A benchmark rule explains in a systematic fashion how policy is data dependent and how future policy depends on the evolution of the short-term outlook. Real-time communication of a benchmark rule can guard against inappropriate deviations from sensible policy, limiting harmful discretion and protecting against basic errors such as the forward guidance trap.

Simple rules that use nowcasts/short-term forecasts of inflation and growth as inputs can serve as a sensible cross-check on policy. Discretion, influenced by optimal control exercises that are guided by model-based longer-term forecasts should be avoided. Similarly, policy should not be based on estimates of unknowable concepts such as *r*-star—the natural real rate of interest. Selecting a simple and robust rule can be based on careful evaluation that places a premium on robustness. An illustration of such analysis, as well as an example rule that

characterized ECB policy well during its first years is presented in Orphanides and Wieland (2012). A simple robust policy rule can protect against episodes of low and high inflation, can protect against unhelpful discretion and can communicate better how policy is likely to change with the evolution of the economy.

### **III. A challenge unique to the ECB: Fragility in sovereign debt markets**

The second challenge I wish to focus on concerns a fundamental flaw in the ECB's implementation of monetary policy that has significantly contributed to the fragility of government bond markets in the euro area since the onset of the euro crisis. This is a frustrating issue to discuss because the nature of the problem and recommendations for improvement have been discussed repeatedly in the past, including at ECB Watchers XXI (Lengwiler and Orphanides, 2020, 2024; Orphanides, 2020). Yet, the ECB has decided against the steps required to correct it.

This is something that is so peculiar and so unique to the ECB, compared to other central banks around the world. The ECB is unique in using its discretionary authority to induce unnecessary fiscal stress. Figure 3 presents a visual illustration of the problem. Consider large, advanced economies represented in the G7. Four of these are outside the euro area. For symmetry, compare these with the four largest states in the euro area, three of which are also in the G7. For all these economies, we can check how reasonably well their central bank implements its policy, including taking care to avoid unnecessary tensions in government bond markets, by comparing 10-year government bond yields to the expectation of the policy rate over 10 years, as reflected in swap markets. If the central bank is operating reasonably well, we should expect to see only a small premium in government bond yields over the expectations of the policy rate. Regardless of the currency. Of course, several factors influence the premium and it can vary over time. The critical point is that with a reasonably good policy implementation framework by the central bank the premium should be fairly small, much like what can be seen in the panel for the four G7 economies with central banks other than the ECB.

When we focus on the euro area, we see a striking difference. Until the Global Financial Crisis, the premiums in euro area government bonds were comparable to all other advanced economies and similarly small. Since the Global Financial Crisis, however, the premiums suggest persistent turmoil. As is evident in the figure, the volatility peaked during what became the euro crisis, roughly between 2010 and 2013. What is notable is that although spreads have narrowed over the past decade, on average, they remain higher than in other advanced economies. The problem has not been resolved. Episodes of unusual volatility and spikes keep recurring, most recently in Spring 2020, at the beginning of the pandemic, and again in Spring and Summer 2022.

Why are euro government bond markets different since the Global Financial Crisis? One hypothesis is that the only source of the difference in premiums is the presence of greater fiscal risks in the euro area compared to all other advanced economies, due to differences in



economic fundamentals. But this makes little sense. We know that's not the answer. Indeed, we can refer to past speeches by ECB officials to confirm that even in the ECB's views, the malfunction in government bond markets cannot be explained by economic fundamentals in the euro area.

An illuminating assessment was provided in 2018 by then ECB Vice President Constâncio:

“The issue stems from the fact that the demotion of national public debt to debt with default risk opens the door, as in any other asset market, to episodes of acute liquidity stress with investors panicking or speculating, leading prices and yields to levels not justified by changes in fundamentals.” (Constâncio, 2018.)

In describing episodes of “acute liquidity distress ... not justified by changes in fundamentals,” Constâncio pointed to policy decisions that compromised the safe asset status of government bonds as the sourced of the problem—the “demotion of national public debt to debt with default risk.” Indeed, this is an accurate description of the problem. But what policy decisions compromised the safe asset status of government debt in the first place? Most important was a decision that the ECB had taken before the crisis that effectively delegated to private credit rating agencies the determination of the collateral eligibility of government debt. The economic damage that this flaw could generate in the euro area was underappreciated by the ECB when the decision was originally taken. In the event, the consequences were severe.

No other central bank is doing something as crazy as this and, of course, the implications are now easy to understand. The ECB reliance on private credit ratings for government debt creates destabilizing cliff effects in the collateral framework. It undermines the safe-asset status of government debt and validates adverse expectational equilibria in sovereign debt markets, causing avoidable debt-roll-over crises.

Undermining the safe asset status of government debt has been the source of significant adverse consequences for the euro area. Since the global financial crisis, we have observed recurring crises in government bond markets: Just in the euro area, not in other advanced economies. Unnecessarily high premiums on government debt have been an important and persistent cause of avoidable fiscal stress in public finances. Just in the euro area.

A 2014 speech by then ECB President Draghi can help us appreciate how the ECB has handicapped fiscal policy in the euro area:

“Turning to fiscal policy, since 2010 the euro area has suffered from fiscal policy being less available and effective, especially compared with other large advanced economies. This is not so much a consequence of high initial debt ratios—public debt is in aggregate not higher in the euro area than in the U.S. or Japan. It reflects the fact that the central bank in those countries could act and has acted as a backstop for government funding. This is an important reason why markets spared their fiscal

authorities the loss of confidence that constrained many euro area governments' market access.” (Draghi, 2014.)

As Draghi explained, fiscal policy was “less available and effective” in the euro area, not because of economic fundamentals but because the ECB was using its discretionary authority to act differently than the central banks of other advanced economies. Without explicitly acknowledging it, Draghi suggested that the ECB could not act in a manner similar to other central banks to avoid unnecessary fiscal stress. However, the ECB has the authority, and the tools to act in the best interest of the euro area, including taking actions needed to avoid unnecessary fiscal stress. Is inducing fiscal stress consistent with the ECB mandate?

To the contrary, inducing fiscal stress is incompatible with sound central banking principles. And yet, ECB decisions over the past 15 years suggest that the ECB holds the view that it has the legitimacy to induce or avert fiscal stress, on a case-by-case basis, with discretionary decisions. This is another example of inappropriate use of discretion.

Solutions to this challenge are available in the form of a sensible rule. We can draw on ECB discretionary decisions relating to the treatment of government debt in the collateral framework to understand how the ECB can address this challenge.

Figure 4 presents a detail of the euro panel in Figure 3 that allows closer examination of premiums since the start of the pandemic. Recall that in March 2020, as governments around the world organized a temporary shutdown of some economic activity in the interest of public health, projections of fiscal needs spiked. In the euro area, this prompted concerns that rating agencies would start downgrading governments. With the collateral framework in place, this implied a significant risk: If these downgrades materialized, the ECB would stop accepting government debt as collateral, causing a debt-rollover crisis. Predictably, premiums spiked.

Once again, the euro area was at risk of coming apart. Initially, the ECB attempted to address this challenge by introducing yet another bond purchase program, the Pandemic Emergency Purchase Programme (PEPP). Purchases of government bonds started in late March 2020, and succeeded in compressing premiums for a few days. But purchases of government bonds proved ineffective, and premiums of several governments started rising significantly once again in April 2020. Faced with another existential crisis, the ECB finally addressed the root cause of the problem on 22 April 2020: Collateral certainty. The ECB effectively suspended its destabilizing reliance on credit ratings to determine collateral eligibility of government debt. This simple decision was sufficient to stabilize markets.

As is evident in the figure, premiums declined significantly after that decision. By the end of 2020 and early 2021, when projections of debt to GDP ratios were historically high, the premiums were even lower than they were before the pandemic. Why? Because the ECB had temporarily suspended this crazy framework that has been contributing to fiscal stress in the first place.

At the ECB Watchers XXI, which took place on 30 September 2020, I expressed my optimism that, having seen the beneficial effects of the temporary suspension of its flawed collateral framework, the ECB would have permanently ended the delegation of the determination of collateral eligibility of government debt to private credit rating agencies. The ECB could have converted the temporary fix to a permanent solution. The ECB could have and should have eliminated cliff effects in its collateral framework on a permanent basis. Unfortunately, this didn't happen. Initially the ECB extended the suspension. However, on 24 March 2022, without providing any supporting analysis, the ECB announced that it would phase out the temporary suspension and would revert to its pre-pandemic collateral framework starting in March 2024.

Predictably, this decision brought back instability in government bond markets. Apparently, the deterioration in the functioning of government bond markets was worse than the ECB anticipated. By July 2022, the ECB was compelled to introduce yet another bond purchase program, the Transmission Protection Instrument (TPI), to contain the fallout. While the TPI did have some effect, it did not correct the underlying problem (Lengwiler and Orphanides, 2024). Instead, the ECB should have corrected its collateral framework, which would eliminate the persistent fragility that continues to plague the euro area's sovereign debt markets.

#### **IV. Conclusion**

The ECB has the authority and the tools to fulfil its mandate better than in the past. The ongoing strategy assessment presents yet another an opportunity to address critical challenges that were left unaddressed in the previous review—challenges that have had serious consequences for the euro area. By adopting sensible rules and eschewing unhelpful discretion, the ECB can enhance the effectiveness of its policies and contribute to the resilience of the euro area. The precarious economic and geopolitical environment that Europe currently faces makes this more important than ever.

Sensible rules are critical for a successful policy strategy. Had a sensible rule on setting the ECB policy rate been in place, the policy miscalibration that led to the post-pandemic inflation spike would have been avoided. Had a sensible rule for the treatment of government debt in the ECB's collateral framework been in place, multiple crises would have been avoided.

The ECB can and should help Europe become stronger. With guidance from sensible rules, the ECB can secure price stability and avoid unwarranted fragility in government bond markets. Reducing fiscal stress can facilitate public investment towards raising productivity, greening the economy and strengthening European defense. Within its mandate, the ECB can serve Europe better than in the past.

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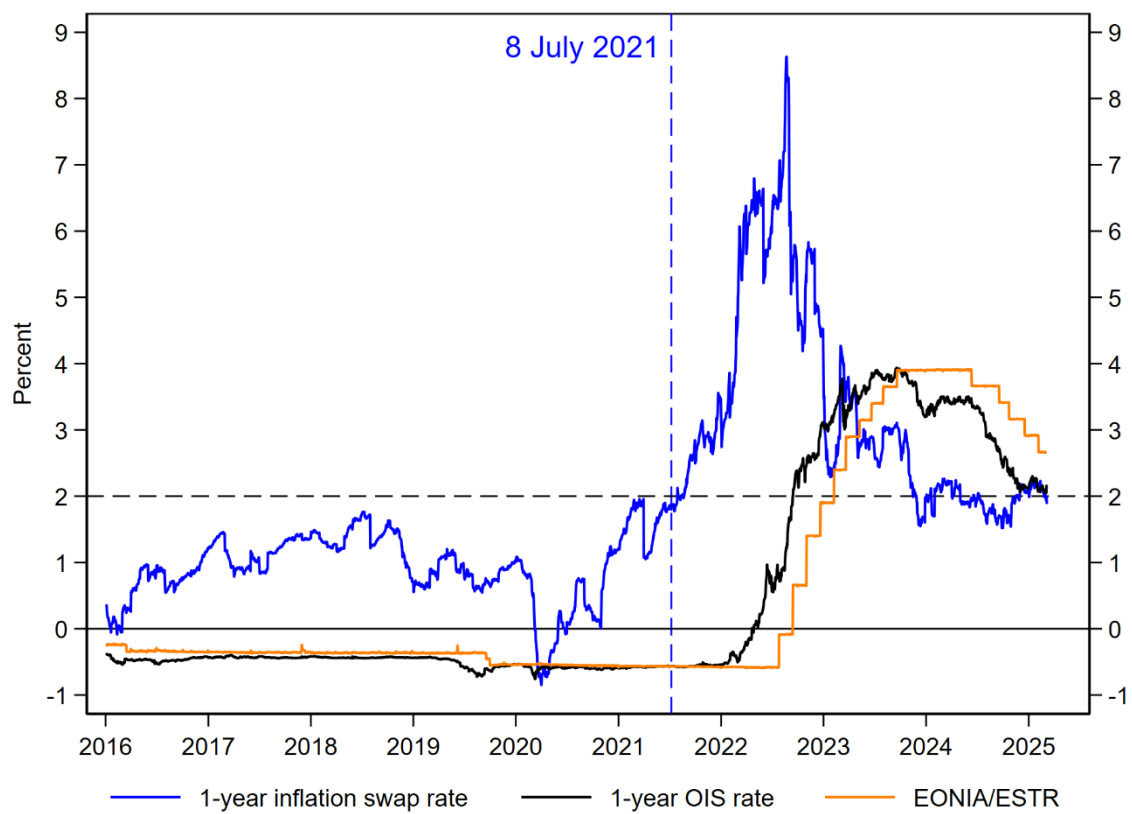
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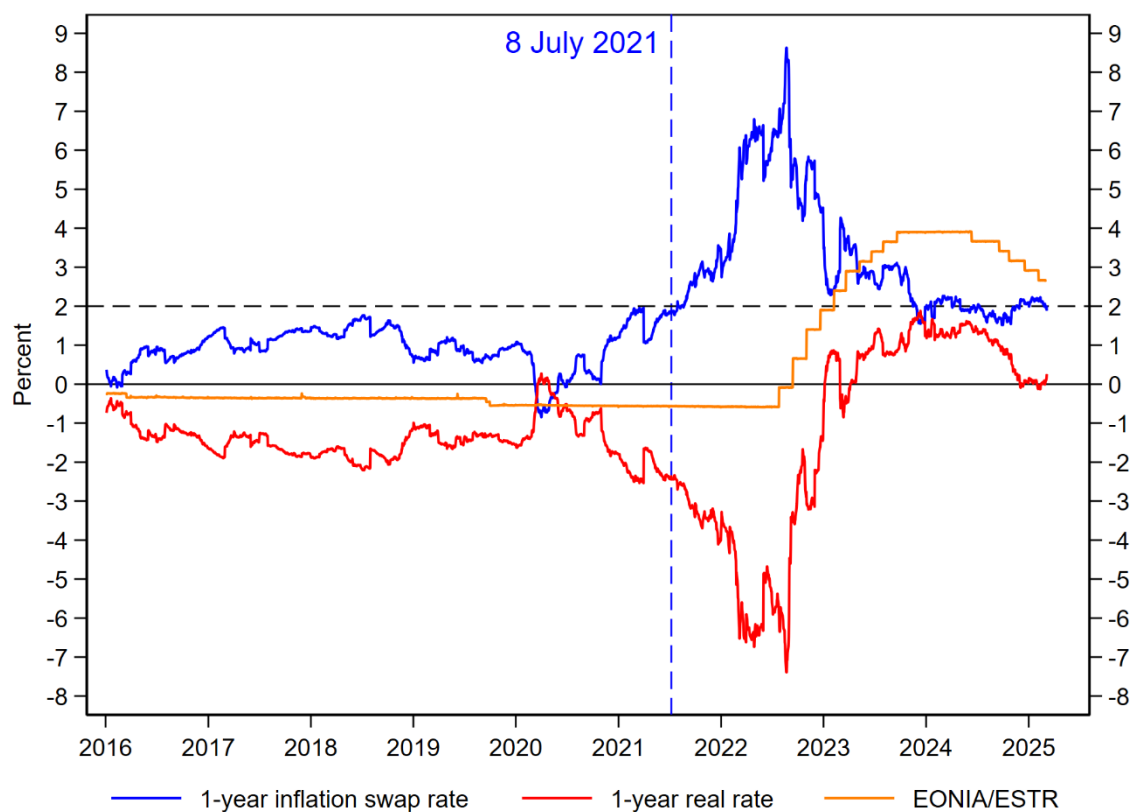
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Figure 1: The post-pandemic inflation policy error



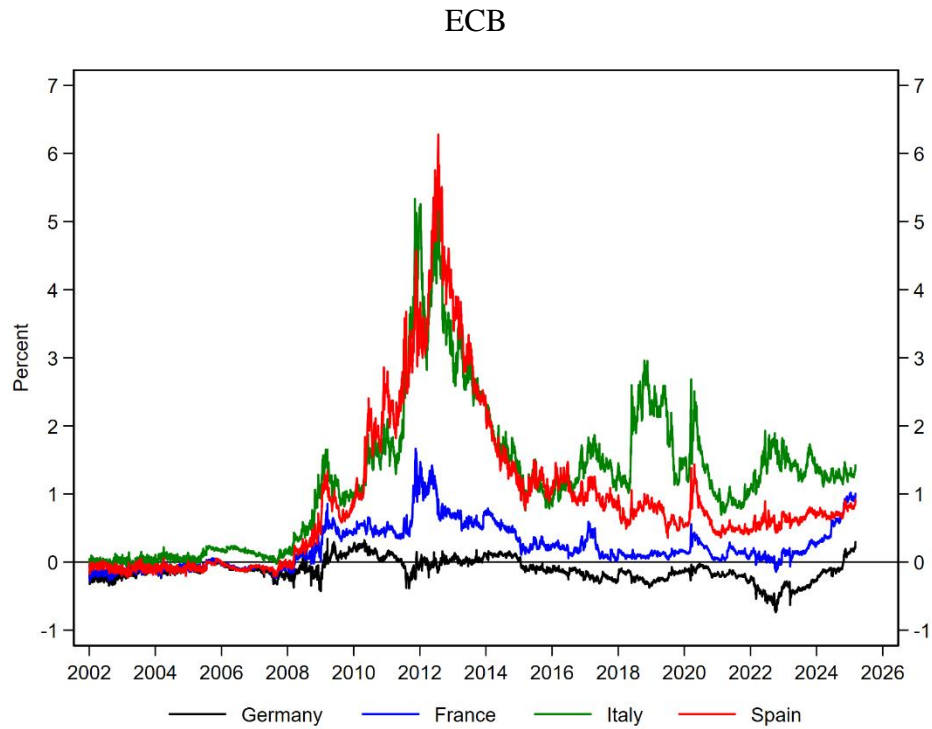
Notes: Vertical line denotes adoption of ECB's revised policy strategy.

Figure 2: Falling into and recovering from the forward guidance trap

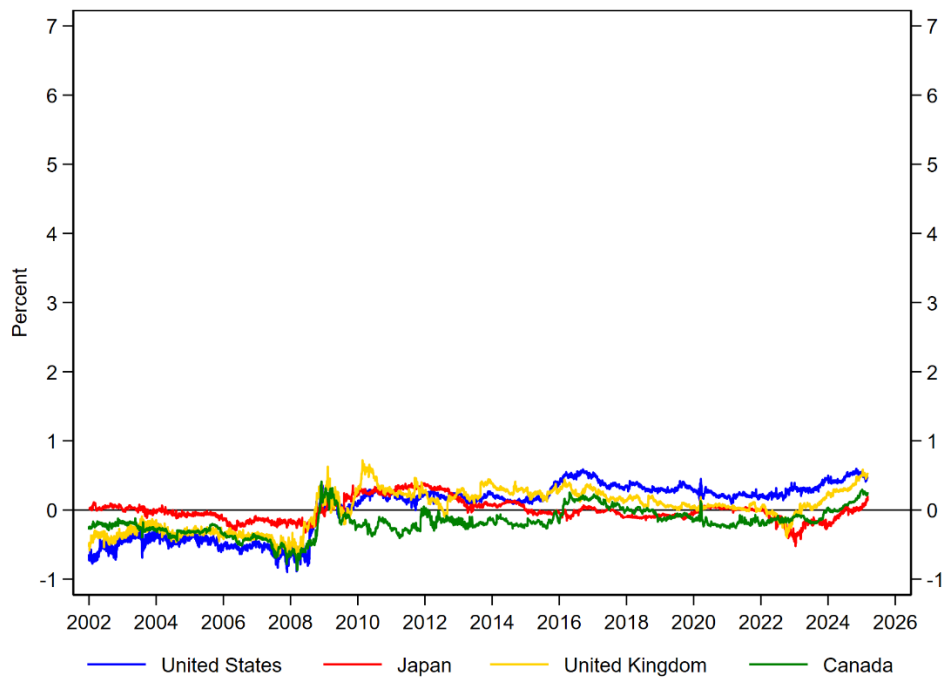


Notes: Real rate reflects OIS rate minus inflation swap rate. Vertical line denotes adoption of ECB's revised policy strategy.

Figure 3: Fragility in sovereign debt

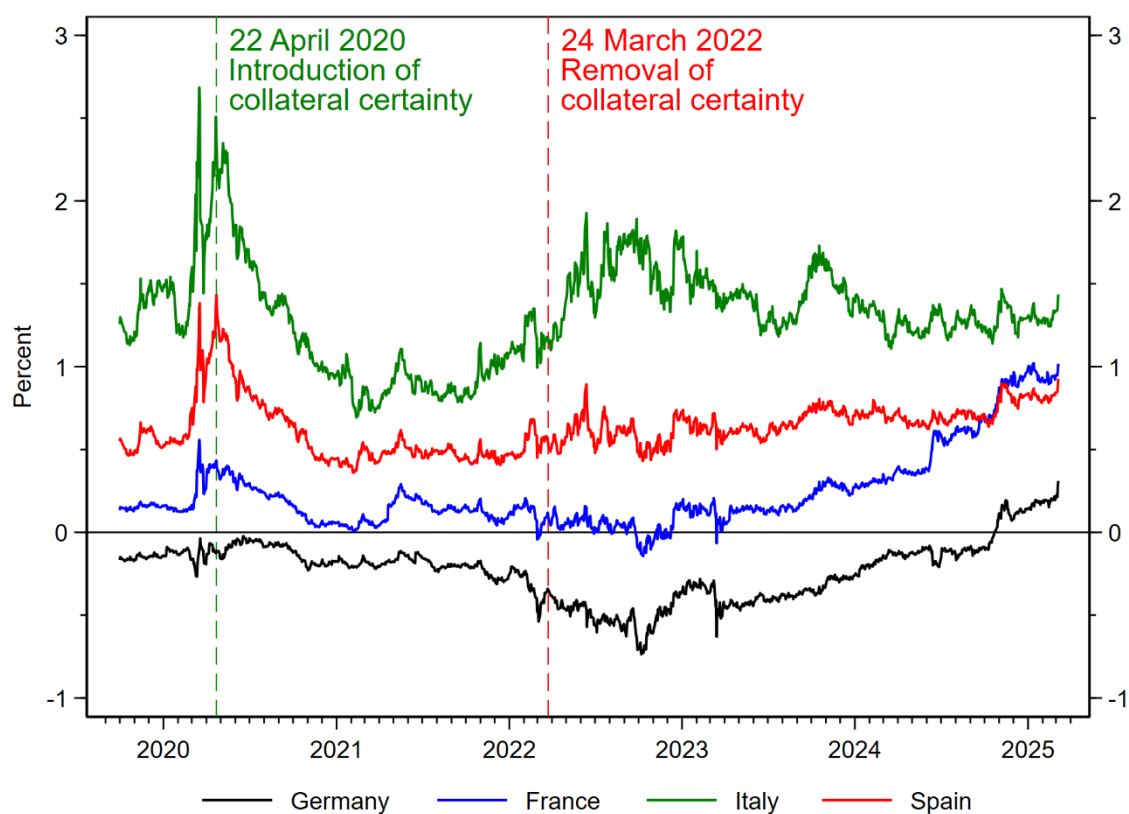


Fed, BOJ, BOE, BOC



Notes: Spread between 10-year government bond yield and 10-year OIS rate or equivalent in respective currency.

Figure 4: The pandemic experience with collateral certainty



Notes: Spread between 10-year government bond yield and 10-year OIS rate.



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