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# Remarks given at the OeNB monetary policy panel[1]

*The ECB's new monetary policy strategy allows the Eurosystem to deal with the effective lower bound of policy rates and persistently low inflation in a much better way than the old framework. At the same time, the new strategy remains well-suited to ensuring price stability in the medium term if inflation is above target. In line with its symmetric target, the Eurosystem must continue to demonstrate its commitment to its inflation target and respond appropriately to changes in the medium-term inflation outlook. The persistence and the extent of recent inflation surprises have been a game changer for the Governing Council's monetary policy assessment. At the moment, there are worrying signs suggesting that the high inflation rates seen at present might translate into elevated medium-term inflation expectations across financial investors, households and firms. For this reason, it has become even more imperative to adapt the monetary policy stance to the changed environment.*

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## 1 Did recent reviews of major central banks' monetary policy strategies focus too much on a state of the world with persistently low inflation?

No, I do not think that such a criticism of the strategy review is appropriate. In my view, it creates a false dilemma between two requirements. The first is how to cope with being at the effective lower bound (ELB) of policy rates, an experience that certainly was a key motive for the strategy. The second is handling situations where inflation is above target, and possibly significantly so. As I see it, the new strategy addresses both requirements convincingly: It allows us to deal with the ELB in a much better way than the old framework and is also well-suited to ensuring price stability in the medium term if inflation is above target.

The Eurosystem's strategy review of 2020 and 2021 took place at a time when the euro area (and other currency areas) had been predominantly concerned with inflation rates that were persistently too low over several years. This is why the new framework includes, for example, an asymmetric reaction function. It implies that, in the event of strongly negative inflation shocks, the monetary policy instruments are to be deployed particularly forcefully. If the policy rates are close to the ELB, the Governing Council can also deploy its instruments more persistently.

Nonetheless, the Governing Council was well aware that the new strategy had to be of a universal nature, and this requirement was considered in the decisions regarding the new strategy. This is reflected most prominently in the decisions on the level of the inflation target and its symmetry.

First, price stability is best maintained by aiming for an inflation rate of 2% over the medium term. This inflation target is only negligibly higher than the policy aim of the previous strategy. While a higher inflation target generally has the potential to provide a larger safety margin for protecting against the risk of deflation and ensuring the effectiveness of monetary policy in response to disinflationary shocks, the Governing

[1] *Policy panel "Monetary policy, policy interaction and inflation in a post-pandemic world with severe geopolitical tensions".*

Council deliberately decided against an inflation target higher than 2%. There was a clear awareness and broad consensus that a higher inflation target, and hence higher average inflation rates, would entail costs that could outweigh the benefits.

Second, the inflation target is symmetric, meaning that downward and upward deviations from the target are equally undesirable. On the one hand, this means that the Eurosystem takes into account the implications of the ELB in order to avoid negative deviations from the inflation target becoming entrenched. On the other hand, and this particularly applies to the current situation, inflation rates above 2% are to be avoided, and, if they persist, this is incompatible with the goal to ensure price stability.

Thus, the new strategy clearly does not neglect upward risks to medium-term inflation. On the contrary, it provides the necessary framework for the Governing Council to act swiftly and resolutely in inflationary environments and is therefore suitable for, and applicable to, the current period of high inflation rates.

## 2 Why do central banks seem so hesitant to tighten their monetary policy stance when it comes to fighting rising inflation?

The Governing Council's decision to hold policy rates at the ELB for such a long time must be viewed against the backdrop of a prolonged period during which inflation was too low. As central banks typically have limited power to stimulate the economy at the ELB, a symmetric target requires especially persistent monetary policy action when faced with large adverse shocks. That means, after undershooting our target for a while, the Governing Council would be willing to accept a temporary overshooting. But the Governing Council would not aim for such an overshooting, which should be moderate and short-lasting anyhow.

In line with our symmetric target, the Eurosystem must constantly demonstrate its commitment to its inflation target and respond appropriately to changes in the medium-term inflation outlook. This also applies when the inflation rate is too high. Otherwise, we risk longer-term inflation expectations becoming entrenched above target.

Earlier this year, there were two main arguments against a faster withdrawal of monetary stimulus. First, the shocks causing the inflation rate to rise were thought to be only temporary in nature. Second, the upside surprises in inflation rates were mostly attributed to supply shocks, such as the supply bottlenecks related to the pandemic and the high energy prices due to the war in Ukraine. Supply shocks induce a policy trade-off and therefore typically require only partial accommodation. However, even if recent developments are seen in that light, monetary policy must react to supply shocks within an environment of catching-up demand and when inflation is already high. The more persistent the shock, the stronger the subsequent price pressure, and the stronger the required reaction.

When I took office as President of the Deutsche Bundesbank in January, I expressed my concerns that elevated inflation could prove more persistent than many expected. In the course of the first quarter, the high inflation became increasingly entrenched, indeed. The persistence and the extent of the inflation surprises have been a game changer for the Governing Council's assessment. Moreover, incoming data have supported the view that price pressures have become more broad-based and longer-lasting.

At the moment, there are worrying signs suggesting that the current high inflation rates might translate into elevated medium-term inflation expectations across financial investors, households and firms. For this reason, it has become even more imperative to adapt the monetary policy stance to the changed environment.

As we all know, a firm anchoring of inflation expectations is crucial for monetary policymakers to be able to steer aggregate demand effectively. This is a prerequisite for fulfilling the mandate of price stability. Therefore, in my view, we should start hiking policy rates soon. Otherwise, there is a risk that we may fall “behind the curve” and longer-term expectations could become less anchored. In that case, the costs of fighting inflation (and re-anchoring expectations) would be much higher.