The ECB / Eurosystem’s monetary policy

1. The mandate and task of monetary policy

The Treaty on the Functioning of the European Union assigns to the Eurosystem the goal of maintaining price stability in the euro area. In particular it states that “the primary objective of the ESCB [European System of Central Banks] shall be to maintain price stability.”

The challenge faced by the ECB can be stated as follows: the Governing Council of the ECB has to influence conditions in the money market, and thereby the level of short-term interest rates, to ensure that price stability is maintained over the medium term.

Money market: The market in which short-term funds are raised, invested and traded, using instruments which generally have an original maturity of up to one year.

Short-term interest rate: The interest rate on a loan or other obligation with a maturity of less than one year.

First, monetary policy is considerably more effective if it firmly anchors inflation expectations, i.e. people’s expectations of future price increases. In this regard, central banks should specify their objectives, elaborate them and stick to a consistent and systematic method for conducting monetary policy, as well as communicate clearly and openly. These are key elements for acquiring a high level of credibility. If a central bank does not keep its word, the public will lose confidence in it and the bank’s credibility will suffer as a result. Credibility is, therefore, a necessary precondition for influencing people’s inflation expectations.

Second, owing to the lags in the effects of interest rate changes on the economy (i.e. the transmission process), changes in monetary policy today will only affect the price level after a number of quarters or years. This means that central banks need to ascertain what policy stance is needed in order to maintain price stability in the future, after all adjustments in the economy have worked through. In this sense, monetary policy must be forward-looking.

The central bank has to be forward-looking, yet it is impossible for monetary policy to offset unanticipated events that have an impact on the economy, or what we call economic shocks. In the case of a shock to the price level (for example, those caused by changes in international commodity prices or indirect taxes) in the short run, some short-term volatility in inflation rates is inevitable. In addition, owing to the complexity of how the monetary policy affects the economy, there is always a high degree of uncertainty surrounding the effects of economic shocks and monetary policy. For these reasons, monetary policy should have a medium-term orientation in order to avoid excessive activism and the introduction of unnecessary volatility into the real economy.

Finally, just like any other central bank, the ECB faces considerable uncertainty about the reliability of the statistics it receives about the economy (the so-called economic indicators), how the euro area economy works, i.e. the structure of the euro area economy and how monetary policy feeds through to the economy, among other things. A successful monetary policy therefore has to be broadly based, taking into account all relevant information in order to understand the factors driving economic developments, and cannot rely on a small set of indicators or a single model of the economy.

The Governing Council of the ECB has adopted and announced a monetary policy strategy to ensure a consistent and systematic approach to monetary policy decisions. This monetary policy strategy embodies the above-mentioned general principles in order to meet the challenges facing the central bank. It aims to provide a comprehensive framework within which decisions on the appropriate level of short-term interest rates can be taken and communicated to the public.

1 A monetary policy strategy is a coherent and structured description of how monetary policy decisions will be made in order for a central bank to achieve its objectives.
2. The main elements of the ECB’s monetary policy strategy

The first element of the ECB’s monetary policy strategy is a quantitative definition of price stability. In addition, the strategy establishes a framework to ensure that the Governing Council assesses all the relevant information and analyses needed to take monetary policy decisions so that price stability over the medium term is maintained.

2.1 Primary objective

The primary objective of the Eurosystem is to maintain price stability in the euro area, thus protecting the international value of the euro, or its purchasing power. Ensuring stable prices is the most important contribution that monetary policy can make in order to achieve a favourable economic environment and a high level of employment. Both high inflation and deflation can be very costly to society economically and socially speaking. Without prejudice to its primary objective of price stability, the Eurosystem also supports the general economic policies in the European Union. Furthermore, the Eurosystem acts in accordance with the principles of an open market economy, as stipulated by the Treaty.

While the Treaty clearly establishes the maintenance of price stability as the primary objective of the ECB, it does not give a precise definition. In order to specify this objective more precisely, the Governing Council of the ECB announced the following quantitative definition in 1998: “Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term”. In 2003 the Governing Council further clarified that, within the definition, it aims to maintain inflation rates below, but close to, 2% over the medium term.

The Governing Council decided to announce to the public a quantitative definition of price stability for a number of reasons. First, by clarifying how the Governing Council interprets the objective it has been assigned by the Treaty, the definition helps to make the monetary policy framework easier to understand (i.e. it makes monetary policy more transparent). Second, the definition of price stability provides a clear and measurable yardstick against which the public can hold the ECB accountable. In case of deviations of price developments from the definition of price stability, the ECB would be required to provide an explanation for such deviations and to explain how it intends to re-establish price stability within an acceptable period of time. Finally, the definition gives guidance to the public, allowing it to form its own expectations regarding future price developments.

The definition of price stability has a number of noteworthy features. First, the ECB has a euro area-wide mandate. Accordingly, decisions regarding the single monetary policy aim to achieve price stability in the euro area as a whole. This focus on the euro area as a whole is the natural consequence of the fact that, within a monetary union, monetary policy can only steer the average money market interest rate level in the area, i.e. it cannot set different interest rates for different regions of the euro area.

2.2 The HICP

The definition also identifies a specific price index – namely the Harmonised Index of Consumer Prices (HICP) for the euro area – as that to be used for assessing whether price stability has been achieved. The use of a broad price index ensures the transparency of the ECB’s commitment to full and effective protection against losses in the purchasing power of money.

The HICP, which is released by Eurostat, the Statistical Office of the European Union, is the key measure for price developments in the euro area. This index has been harmonised across the various countries of the euro area with the aim of measuring price developments on a comparable basis. The HICP is the index that most closely allows one to approximate the changes over time in the price of a representative basket of consumer expenditures in the euro area.

You will find more information and the data you need on the ECB website: https://www.ecb.europa.eu/stats/macroeconomic_and_sectoral/hicp/html/index.en.html

2.3 Reasons for aiming at inflation rates of below, but close to, 2%

By referring to an “increase in the HICP of below 2%”, the definition makes it clear that both inflation above 2% and deflation (i.e. declines in the price level) are inconsistent with price stability. In this respect, the explicit indication by the ECB to aim to maintain the inflation rate at a level below, but close to, 2% signals its commitment to provide an adequate margin to avoid the risks of deflation.

2 The legal and political obligation of an independent institution to properly explain and justify its decisions to the public and their elected representatives, thereby making it responsible for fulfilling its objectives. The ECB is accountable to the people of Europe and, more formally, to the European Parliament.
A safety margin against deflation

Referring to an “increase in the HICP of below, but close to, 2%” provides a safety margin against a persistent fall in the average level of prices in the economy, i.e. deflation. While deflation implies similar costs for the economy as inflation, it is particularly important that deflation is avoided because, once it occurs, it may become entrenched as a result of the fact that nominal interest rates cannot fall below zero, as normally no lender would be willing to lend money to someone else if he/she expected less money to be paid back after a certain period. In a deflationary environment monetary policy may therefore not be able to sufficiently stimulate aggregate demand by using its interest rate instrument. Any attempt to bring the nominal interest rate below zero would fail, as the public would prefer to have cash rather than to lend or hold deposits at a negative rate. Although some monetary policy actions can still be carried out even when nominal interest rates are at zero, the effectiveness of these alternative policies is not fully certain. It is thus preferable for monetary policy to have a safety margin against deflation. By aiming at an increase of the HICP of below, but close to, 2%, a possible measurement bias in the HICP, that is to say overestimating the true price increase in the economy, and the potential implications of inflation differentials in the euro area, with some countries having low inflation while others have high, are also taken into account.

2.4 The medium-term orientation of the ECB's monetary policy

A key aspect of the ECB's monetary policy is that it aims to pursue price stability ‘over the medium term’. As outlined above, this reflects the consensus that monetary policy cannot, and therefore should not, aim to attempt to fine-tune developments in prices or inflation over short horizons of a few weeks or months. Changes in monetary policy only affect prices with a time lag, and the magnitude of the eventual impact is uncertain. This implies that monetary policy cannot offset all unanticipated disturbances to the price level. Some short-term volatility in inflation is therefore inevitable.

An economy is continuously subject to largely unforeseeable shocks that also affect price developments. At the same time, monetary policy can only affect price developments with significant time lags, which are variable and, like most economic relationships, highly uncertain. Against this background, it would be impossible for any central bank to keep inflation at a specific point target at all times or to bring it back to a desired level within a very short period of time. Consequently, monetary policy needs to act in a forward-looking manner and can only maintain price stability over longer periods of time. This is the reasoning that lies at the heart of the ECB's medium-term orientation.

The "medium term" notion deliberately retains some flexibility with regard to an exact time frame. This reflects the fact that it is not advisable to specify ex ante a precise horizon for the conduct of monetary policy, since the time frame in which it feeds through to the economy is variable and uncertain. An excessively aggressive policy response to restore price stability within a very short time span may, under these circumstances, risk incurring a significant cost in terms of output and employment volatility which, over a longer horizon, could also affect price developments. In these cases, it is widely recognised that a gradual response of monetary policy is appropriate both to avoid unnecessarily high volatility in real activity and to maintain price stability over a longer horizon. Thus, the medium-term orientation also gives the ECB the flexibility required to respond in an appropriate manner to the different economic shocks that might occur. At the same time, it should be clear that, from an ex post perspective, the ECB can be held accountable only for trends in inflation.

2.5 The two pillars of the ECB's monetary policy strategy

The ECB's approach to organising, evaluating and cross-checking the information relevant for assessing the risks to price stability is based on two analytical perspectives, referred to as the two “pillars”.

In the ECB’s strategy, monetary policy decisions are based on a comprehensive analysis of the risks to price stability. This analysis is organised on the basis of two complementary perspectives on the determination of price developments. The first perspective is aimed at assessing the short to medium-term determinants of price developments, with a focus on real activity and financial conditions in the economy. It takes account of the fact that price developments over those horizons are influenced largely by the interplay of supply and demand in the goods, services and factor markets. The ECB refers to this as the “economic analysis”. The second perspective, referred to as the “monetary analysis”, focuses on a longer-term horizon, exploiting the long-run link between money and prices. The monetary analysis serves mainly as a means of cross-checking, from a medium to long-term perspective, the short to medium-term indications for monetary policy coming from the economic analysis.

The two-pillar approach is designed to ensure that all relevant information is used in the assessment of the risks to price stability and that appropriate attention is paid to different perspectives and the cross-checking of information in order to come to an overall judgement of the risks to price stability. It represents, and conveys to the public, the notion of diversified analysis and ensures robust decision-making based on different analytical perspectives.
2.5.1 Economic analysis

The economic analysis focuses mainly on the assessment of current economic and financial developments and the implied short to medium-term risks to price stability. The economic and financial variables that are the subject of this analysis include, for example, developments in overall output, aggregate demand and its components; fiscal policy; capital and labour market conditions; a broad range of price and cost indicators; developments in the exchange rate, the global economy and the balance of payments; financial markets; and the balance sheet positions of euro area sectors. All these factors are helpful in assessing the dynamics of real activity and the likely development of prices from the perspective of the interplay between supply and demand in the goods, services and factor markets at shorter horizons.

Real economic and financial indicators

In the framework of its economic analysis, the ECB focuses mainly on the assessment of current economic and financial developments and the implied short to medium-term risks to price stability.

Regarding the analysis of real economy indicators, the ECB regularly reviews developments in overall output, demand and labour market conditions, a broad range of price and cost indicators, and fiscal policy, as well as the balance of payments for the euro area.

For instance, in terms of price and cost developments, alongside the HICP and its components, price developments in the industrial sector, as measured by producer prices, are analysed because changes in production costs may feed through to consumer prices. Labour costs, which are an important element of overall production costs, may have a significant impact on price formation.Labour cost statistics also provide information on the competitiveness of the euro area economy.

Second, indicators of output and demand (national accounts, short-term statistics on activity in industry and services, orders, and qualitative survey data) provide information on the cyclical position of the economy, which in turn is relevant for the analysis of prospects for price developments. Furthermore, labour market data (on employment, unemployment, vacancies and labour market participation) are important for monitoring economic developments and assessing structural changes in the functioning of the euro area economy. Moreover, the government sector represents a substantial part of economic activity; information on both financial and non-financial public sector accounts is essential.

Third, balance of payments statistics, along with external trade statistics, provide information on developments in exports and imports which may affect inflationary pressures via their impact on demand conditions. These data also allow external trade prices – currently proxied by export and import unit value indices – to be monitored. These indices help to assess, in particular, the potential impact on import prices of movements in the exchange rate and changes in commodity prices (such as oil). In short, these indicators help to assess movements in aggregate demand, aggregate supply and the degree of capacity utilisation.

Developments in financial market indicators and asset prices are also closely monitored. Movements in asset prices may affect price developments via income and wealth effects. For example, as equity prices rise, share-owning households become wealthier and may choose to increase their consumption. This will add to consumer demand and may fuel domestic inflationary pressures. Conversely, when equity prices fall, households may well reduce consumption. An additional way in which asset prices can have an impact on aggregate demand is via the value of collateral that allows borrowers to obtain more loans and/or to reduce the risk premia demanded by lenders/banks. Lending decisions are often influenced to a large extent by the amount of collateral. If the value of collateral falls, then loans will become more expensive and may even be difficult to obtain at all, with the result that spending, and therefore demand, will fall.

Asset prices and financial yields can also be analysed to derive information about the expectations of the financial markets, including expected future price developments. For example, when buying and selling bonds, financial market participants implicitly reveal their expectations about future developments in real interest rates and inflation. Using a variety of techniques, the ECB can analyse financial prices to extract the markets’ implicit expectations about future developments. Asset markets, and therefore asset prices, are by their very nature forward-looking. Changes in asset prices therefore largely reflect “news” – information about developments that the financial markets had not been expecting. In this sense, the monitoring of asset prices might help to identify shocks that are currently hitting the economy, in particular shocks to expectations about future economic developments. By analysing financial markets, statistical information on financial asset prices from various sources can also be assessed. In addition, the ECB collects certain statistical information itself.
Developments in the exchange rate are also closely assessed for their implications for price stability. Exchange rate movements have a direct effect on price developments through their impact on import prices. Although the euro area is a relatively closed economy compared with its individual member countries, import prices do affect domestic producer and consumer price developments. Changes in the exchange rate may also alter the price competitiveness of domestically produced goods on international markets, thereby influencing demand conditions and, potentially, the outlook for prices.

In this analysis, due attention is paid to the need to identify the origin and the nature of shocks hitting the economy, their effects on cost and pricing behaviour and the short to medium-term prospects for their propagation in the economy. For example, the appropriate monetary policy response to the inflationary consequences of a temporary rise in the international price of oil might be different from the appropriate response to higher inflation resulting from the labour cost implications of wage increases not matched by productivity growth. The former is likely to result in a transient and short-lived increase in inflation which may quickly reverse. As such, if this shock does not lead to higher inflation expectations, it may pose little threat to price stability over the medium term. In the case of excessive wage increases, there is the danger that a self-sustaining spiral of higher costs, higher prices and higher wage demands may be created. To prevent such a spiral from occurring, a strong monetary policy action to reaffirm the central bank’s commitment to the maintenance of price stability, thereby helping to stabilise inflation expectations, may be the best response.

To take appropriate decisions, the Governing Council needs to have a comprehensive understanding of the prevailing economic situation and must be aware of the specific nature and magnitude of any economic disturbances threatening price stability.


In the context of the economic analysis, the macroeconomic projections play an important role. The projections, which are produced by the staff, help to structure and summarise a large amount of economic data and ensure consistency across different sources of economic evidence. In this respect, they are a key element in sharpening the assessment of economic prospects and the short to medium-term fluctuations of inflation around its trend.

**Euro area macroeconomic projections**

The word “projection” is used in order to emphasise that the published projections are the results of a scenario based on a set of underlying technical assumptions, one of which is that short-term market interest rates move in line with market expectations. Projections are produced on this basis in many central banks in order to best inform monetary policy decision-makers about what could happen if policy rates were to follow what market participants expect. In view of this, it should be clear that projections are not necessarily the best predictor of future outcomes. In fact, if the projections were to show that there is a threat to price stability looking ahead, it would represent a scenario that is unlikely to materialise in practice, since monetary policy will always act to address any such threats to price stability. Therefore, the macroeconomic projections of inflation should not be seen as questioning the commitment of the Governing Council to maintaining price stability over the medium term. Wage and price-setters (i.e. governments, firms and households) should rely on the ECB’s quantitative definition of price stability and especially the aim to keep inflation below, but close to, 2% as the best prediction of medium and long-term price developments.

Although they play a useful role, the macroeconomic projections have their limitations. Why? Because they are based on a simplified representation of the economy, what is called an economic model, and therefore cannot incorporate all relevant information. In particular, useful information, such as that contained in monetary aggregates, is not easily integrated into the framework used to produce the projections. The projections also involve some judgement and specific assumptions that can change rapidly, such as those concerning oil prices or exchange rates.

For all these reasons, macroeconomic projections play an important but not all-encompassing role in the ECB’s monetary policy strategy. The Governing Council evaluates them together with many other pieces of information and forms of analysis organised within the two-pillar framework. These include monetary analysis and analyses of financial prices, individual indicators and the forecasts of other institutions. The Governing Council neither assumes responsibility for the projections nor does it use the macroeconomic projections as its only tool for organising and communicating its assessment.
The data you need are provided on the ECB website:

2.5.2 Monetary analysis
The ECB singles out money from within the set of selected key indicators that it monitors and studies closely. This decision was made in recognition of the fact that monetary growth and inflation are closely related in the medium to long run. This widely accepted relationship provides monetary policy with a firm and reliable nominal anchor beyond the horizons conventionally adopted to construct inflation forecasts. Therefore, assigning money a prominent role in the strategy was also a tool to underpin its medium-term orientation. Indeed, taking policy decisions and evaluating their consequences not only on the basis of the short-term indications stemming from the analysis of economic and financial conditions but also on the basis of monetary and liquidity considerations allows a central bank to see beyond the transient impact of the various shocks and not to be tempted to take an overly activist course.

Monetary aggregates
Given that many different financial assets are close substitutes, and that the nature and characteristics of financial assets, transactions and means of payment are changing over time, it is not always clear how money should be defined and which financial assets belong to which definition of money. Central banks usually define and monitor several monetary aggregates.

Financial assets: Any asset that is
i) cash; or
ii) a contractual right to receive cash or another financial instrument from another enterprise; or
iii) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or
iv) an equity instrument of another enterprise.

The ECB’s definitions of euro area monetary aggregates are based on harmonised definitions of the money-issuing sector and the money-holding sector as well as of categories of monetary financial institution (MFI) liabilities. The money-issuing sector comprises MFIs resident in the euro area. The money-holding sector includes all non-MFIs resident in the euro area, excluding the central government sector.

Based on conceptual considerations and empirical studies, and in line with international practice, the Eurosystem has defined a narrow (M1), an intermediate (M2) and a broad monetary aggregate (M3). These aggregates differ with regard to the degree of liquidity of the assets they include.

M1 includes currency, i.e. banknotes and coins, as well as balances that can immediately be converted into currency or used for cashless payments, such as overnight deposits.

M2 comprises M1 and, in addition, deposits with an agreed maturity of up to two years or redeemable at a period of notice of up to three months. These deposits can be converted into components of narrow money, but some restrictions may apply, such as the need for advance notification, penalties and fees.

M3 comprises M2 and certain marketable instruments issued by the resident MFI sector. These marketable instruments are repurchase agreements, money market fund shares/units and debt securities with a maturity of up to two years (including money market paper). A high degree of liquidity and price certainty make these instruments close substitutes for deposits. As a result of their inclusion, broad money is less affected by substitution between various liquid asset categories than narrower definitions of money, and is more stable.
Holdings by euro area residents of liquid assets denominated in foreign currencies can be close substitutes for euro-denominated assets. Therefore, the monetary aggregates include such assets if they are held with MFIs located in the euro area.

You will find more information on the ECB website:

2.6 Analysis of “special factors”
Monetary developments may, at times, also be influenced by “special factors” (factors which are not part of the regular monetary analysis) caused, for example, by institutional changes, such as modifications to the tax treatment of interest income or capital gains. These special factors can cause changes in money holdings since households and firms will respond to changes in the attractiveness of bank deposits included in the definition of the monetary aggregate M3 relative to alternative financial instruments. However, monetary developments caused by these special factors may not be very informative about longer-term price developments. Consequently, monetary analysis at the ECB tries to focus on underlying monetary trends by including a detailed assessment of special factors and other shocks influencing money demand.

2.7 Cross-checking information from the two pillars
Regarding the Governing Council’s decisions on the appropriate stance of monetary policy, the two-pillar approach provides a cross-check of the indications that stem from the shorter-term economic analysis with those from the longer-term-oriented monetary analysis. As explained in more detail above, this cross-check ensures that monetary policy does not overlook important information relevant for assessing future price trends. All complementarities between the two pillars are exploited, as this is the best way to ensure that all the relevant information for assessing price prospects is used in a consistent and efficient manner, facilitating both the decision-making process and its communication (see chart below). This approach reduces the risk of policy error caused by the over-reliance on a single indicator, forecast or model. By taking a diversified approach to the interpretation of economic conditions, the ECB’s strategy aims at adopting a robust monetary policy in an uncertain environment.

The stability-oriented monetary policy strategy of the ECB

For data on ECB interest rates: