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# Making ECB monetary policy fit for bad times

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**The ECB should adapt to a world with more frequent inflation shocks and thoroughly revise its monetary policy strategy framework.**

The **European Central Bank's (ECB) monetary policy strategy from 2021** focuses on preventing inflation that is, in its view, too low in the long term. However, in the future, high inflation is much more likely. The ECB should take this into account in its ongoing revision of its monetary policy strategy. When the next inflation shock hits, the ECB must not remain on the sidelines as it did in 2021/22.

## Supply shocks have become more likely ...

There are strong arguments that the risks have shifted permanently towards higher inflation. After all, shocks that suddenly reduce the supply of goods and drive prices upwards have become more likely. For example, Donald Trump's massive tariff increases could trigger further trade conflicts. This could happen if the EU retaliates with tariffs against China flooding the EU with goods it can no longer export to the USA. Higher tariffs would then make imports more expensive in the EU and fuel inflation. Additionally, the military withdrawal of the Americans from Europe and other regions could increase the likelihood of crises and wars that disrupt supply chains and raw material deliveries, causing inflation to rise quickly. Sudden shortages and price spikes in food have already become more frequent due to climate change.

## ... and could trigger more frequent periods of high inflation in the future

Such supply shocks could trigger prolonged periods of high inflation in the future. Many economies suffer from labor shortages due to the shrinking share of the working-age population. Trade unions are in a strong negotiating position and can enforce significantly higher wage increases, which can turn temporary inflation shocks into multi-year periods of high inflation.

## So far, the ECB looks through supply-side inflation shocks.

Until now, the ECB has tended to "look through" supply-side inflation shocks and wait. After all, it sees itself in a dilemma. A supply shock increases inflation, suggesting higher interest rates. At the same time, inflation reduces consumers' purchasing power and burdens the economy, which would call for lower interest rates.

However, the great inflation that began a year after the outbreak of COVID-19 demonstrates how dangerous such a passive strategy is. When the overall economic demand, fueled by generous COVID-19 relief measures, encountered a reduced supply due to lockdowns and disrupted supply chains, consumer prices began to rise more quickly – already a year before the start of the Ukraine war.

But the ECB, adhering to its strategy of "looking through", only started to raise its interest rates in mid-2022, when inflation had already exceeded eight percent. This way-too-late response significantly contributed to the severity and persistence of the inflation.

## Revising the monetary policy strategy

To ensure this does not happen again in the future, the ECB should revise two aspects of its monetary policy strategy:

- Firstly, it should no longer commit in advance to a specific monetary policy within the framework of so-called forward guidance. With inflation shocks likely to occur more frequently in the future, it needs more flexibility. The ECB should not in advance accept a temporary overshooting of its 2% inflation target even if inflation was previously below it. Companies and citizens must be able to trust that the ECB will promptly tighten its monetary policy after an inflation shock if necessary.

- Secondly, the ECB should no longer closely tie its monetary policy to its medium-term inflation forecasts, as these have proven to be chronically unreliable. For example, at the end of 2021, when inflation had already visibly picked up, ECB economists predicted a medium-term return to its inflation target, which did not materialize. The ECB thus mistakenly labeled the inflation as transitory and failed to counteract for too long. Instead of relying on its unreliable forecasts, the ECB should pay more attention to already published inflation indicators, such as inflation excluding the volatile prices of energy and food, or wage data, which often better indicate price risks.

The revision of the monetary policy strategy offers the ECB the opportunity to adapt to a world with more frequent inflation shocks. Only if it no longer dismisses these shocks as temporary and counteracts them decisively will the recent inflation episode remain an exception.

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