Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

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The ECB will operate as a risk manager

With its latest strategic review, the European Central Bank has embarked on what is arguably its most profound transformation since its establishment in 1998.

Although it has not explicitly framed it in these terms, the ECB is moving away from a strictly rules-based approach toward greater discretion in setting policy priorities. This shift, while welcome, also carries significant risks.

At first glance, the changes to the ECB's policy framework may appear relatively modest.

The medium-term inflation objective is still 2%, and the principle of symmetry – which treats rates above or below the target as equally undesirable – remains in place.

But the most meaningful shift lies in how the ECB defines and delivers on its mandate.

While European Union treaties establish price stability as the ECB's sole objective, policymakers have considerable discretion in interpreting that goal.

Under its updated approach, the ECB will assess the proportionality of its decisions by weighing the benefits of its policies against potential costs and risks to the real economy and financial system.

Monetary-policy decisions will no longer be guided exclusively by "the most likely path of inflation." Instead, the ECB will operate as a risk manager.

The inflation objective may lose its primacy

This move allows the ECB to refrain from implementing monetary measures that, while necessary to maintain medium-term price stability, may have severe side effects or prove mostly ineffective.

Consequently, the inflation objective may lose its primacy, and larger or prolonged deviations from it could be tolerated.

In a speech outlining the new strategy, ECB President Christine Lagarde emphasized that such deviations would be allowed only if inflation expectations remain well-anchored.

She argued that a "persistent" policy response could serve as a substitute for a "forceful" one. In other words, the ECB could favor gradual and sustained interest-rate increases over sharp hikes.

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Yet this reasoning is fundamentally flawed, as the two approaches are not equally effective – especially during crises, when trade-offs become more apparent and the cost of inaction rises.

Between 2015 and 2019, for example, then-Bundesbank President Jens Weidmann repeatedly criticized the ECB's large-scale bond purchases, which drove German sovereign bond yields into negative territory, unsettled financial markets, and increased pressure on financial institutions.

Weidmann's criticism was well-founded, but the ECB's previous policy framework provided no mechanism to weigh such consequences against economic or financial-stability objectives.

Under its new strategy, the central bank has the tools to chart a different course in similar situations.

The realities of a global economy

The ECB's revised approach reflects the realities of a global economy shaped by frequent shocks, from financial and debt crises to pandemics, geopolitical conflict, energyprice spikes, and environmental disasters.

In today's world, it is unrealistic to expect central banks to maintain price stability at all times using conventional tools, particularly when doing so risks significant collateral damage and undermines public trust.

Against this backdrop, the ECB's new strategy appears both timely and prudent, providing policymakers with the flexibility needed to navigate a challenging economic landscape.

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And which economic factors will officials consider when making such decisions? Will the focus be limited to financial stability, employment, and growth, or will it also extend to issues like inequality, innovation, and European integration?

The United States offers valuable insights into how to approach these questions.

The Federal Reserve has a dual mandate, enabling it to strike a balance between its two primary goals: maintaining price stability and achieving maximum employment.

By contrast, the ECB is formally bound by its single objective. But the bank's new strategy effectively broadens its mandate, potentially allowing a wider range of considerations to take precedence over the inflation objective when necessary.

Three key risks

Still, three key risks stand out. The first is a loss of credibility. A central bank's effectiveness depends not only on its policy tools, but also on its ability to anchor inflation expectations.

If the ECB's actions appear erratic, confidence in its commitment to price stability may falter.

To preserve trust, policymakers must define and communicate the principles guiding their decisions, thereby setting limits on their discretion.

Second, greater flexibility increases the risk of communication breakdown and market uncertainty.

With its new strategy, the ECB has taken a bold and necessary step – one that acknowledges the realities of a multipolar, crisis-prone world

The ECB's Governing Council – a political body dominated by national central-bank governors – already struggles to deliver a unified message, as members often represent the interests and policy preferences of their home countries.

Germany, for example, has a deep-rooted political and cultural aversion to inflation and typically advocates tighter monetary policy, while heavily indebted member states tend to support a more expansionary approach.

As monetary policymakers begin to consider factors beyond price stability, the likelihood of internal disagreements will grow, making consensus harder to achieve. Inconsistent messaging, in turn, could create uncertainty about the ECB's policy direction and contribute to market volatility.

Lastly, the ECB risks losing some of its de facto independence. A more flexible strategy could open the door for increased political pressure.

For example, governments might push for looser monetary policy to create fiscal space or accommodate higher debt levels. This dynamic could lead to a form of fiscal dominance, with far-reaching implications for the ECB's autonomy and long-term credibility.

With its new strategy, the ECB has taken a bold and necessary step – one that acknowledges the realities of a multipolar, crisis-prone world.

But it must now clearly articulate how it will assess potential trade-offs, under what conditions it might depart from its traditional policy responses, and how it plans to ensure that greater discretion does not undermine its effectiveness.

Only by pairing strategic flexibility with enhanced transparency and clear communication can the ECB protect its independence and meet the growing demands of an increasingly unstable global economy. Its credibility – and influence – depend on it.

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