

The price stability policy of the European Union

ISSN 1857-9787

UDK 338.532.64(4-672EU)

336.748.1:338.532.64(4-672EU)

338.23:336.74]:338.532.64(4-672EU)

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Abstract

The economy works best when there is price stability. That means the economy needs to guard against an inflation rate—the rate at which the overall prices of goods and services change over time—that is either too low or too high. Price increases should be small enough not to create the problems that come with high inflation for people and businesses. Stability makes it possible to avoid the costs of inefficiency arising from the presence of nominal rigidities, reducing the costs of inefficiency created by inflation which is a tax on the money supply. Also, price stability avoids the negative redistributive effects of inflation. The negative effect of inflation on income and wealth varies across different groups in society, with higher inflation being particularly harmful to low-income households with limited investment options. The presence of inflation creates distortions because taxes are levied in nominal value and there is no full indexation. Price stability reduces the volatility of inflation, which in turn reduces uncertainty and market interest rates, and this motivates people to invest. Price stability helps maintain social cohesion.

Keywords: businesses, economy, inflation, income, expenses.

1. Characteristics of price stability and inflation.

Volatile inflation particularly affects low-income households because they have fewer resources to protect themselves. When prices are stable, everyone is better off: price stability supports economic growth and employment and allows people to make more confident plans when making decisions about borrowing, saving and expanding businesses. When inflation is low, stable and predictable, it helps people and businesses better plan their savings, spending and investments. It helps the economy grow, in turn creating jobs and prosperity:¹

Frequent changes in individual prices are quite normal in market economies, even if there is overall price stability. Changes in the supply and demand of individual goods or services inevitably lead to changes in their prices:²

- ✓ Inflation and deflation are important economic phenomena that have negative consequences for the economy. Basically, inflation is defined as a general, or broad-based, increase in the prices of goods and services over a longer period of time, which consequently leads to a decline in the value of money, and thus its purchasing power.

¹ Benefits of price stability - European Central Bank, (2022), <https://www.ecb.europa.eu> › i.

² European Central Bank (ECB) - Price Stability: Why is it Important for you?, <https://www.ecb.europa.eu> › pub › pdf › other.

- ✓ Deflation is often defined as the opposite of inflation, namely as a situation in which the overall price level falls over an extended period.
- ✓ When there is no inflation or deflation, it can be said that there is price stability if, on average, prices neither rise nor fall, but remain stable.
- ✓ Price stability prevents costs and brings important benefits to all citizens. There are several ways in which price stability helps achieve high levels of economic welfare, e.g. is. in the form of high employment.
- ✓ Price stability makes it easier for people to identify changes in the prices of goods expressed relative to other goods (ie, "relative prices") because such changes are not hidden by fluctuations in the overall price level. For example, suppose the price of a certain product increases by 3%. If the general price level is stable, consumers know that the relative price of this product will rise and may therefore decide to buy less of it. However, if there is high and volatile inflation, it is more difficult to know the relative price.

Price stability implies avoiding both prolonged inflation and deflation:³

Inflation is a rise in the general level of prices of goods and services in an economy over an extended period of time resulting in a decline in the value of money and purchasing power.

- Too rapid inflation is negative for many reasons: it complicates the decision-making process in the economy and
 - ✓ slows economic growth.
 - ✓ in addition, inflation reduces the value of savings.
 - ✓ Deflation is a reduction in the general price level of goods and services over a longer period of time.
- ❖ Deflation is a reduction in the general price level of goods and services over a longer period of time.
- Deflation is accompanied by the threat of slowing economic growth, as the general price level falls, causing people to delay consumption and companies to delay investment. An inflationary gap may emerge that is very difficult to overcome. The real value of non-performing loans is increasing, which means that borrowers are facing difficulties, and loan losses are also a threat to financial institutions. It is often difficult for enterprises to reduce wages, even if the cost of their production is falling. It causes an increase in unemployment and the number of bankruptcies.
- ❖ Price stability contributes to achieving high levels of economic activity and employment while improving the transparency of the price mechanism. Under price stability, people can recognize changes in relative prices (ie, prices between different goods), without being confused by changes in the overall price level. This allows them to bring:
 - ✓ well-informed decisions about consumption and investment and to allocate resources more efficiently;
 - ✓ reduction of the inflation risk premium in interest rates (ie compensation creditors seek for the risks associated with holding nominal assets). This lowers real interest rates and increases incentives to invest;
 - ✓ avoiding unproductive activities to protect against the negative impact of inflation or deflation;

³ Importance of price stability | Eesti Pank, (2024), <https://www.eestipank.ee> › im,

- ✓ reducing the distortions of inflation or deflation, which can exacerbate the distortion of the impact on economic behavior of taxation and social security;
 - ✓ preventing arbitrary redistribution of wealth and income as a result of unexpected inflation or deflation.
- ❖ Price stability is an annual increase in the Harmonized Index of Consumer Prices for the Eurozone below 2%. Price stability must be maintained on a medium-term perspective." An inflation rate below but close to 2% is low enough to allow the economy to fully benefit from price stability. It also underlines the Eurosystem's obligation to guarantee an adequate inflation rate in order to avoid the risk of deflation. This is important to keep nominal interest rates above zero. In a deflationary environment, monetary policy may not be able to sufficiently stimulate aggregate demand using its interest rate instrument. This makes the fight against monetary policy deflation more difficult than the fight against inflation.

2. Price stability and monetary equilibrium

The main task of the ECB is to keep prices stable. This is the best contribution that central banks can make to improving the individual well-being of people:⁴

- Stable prices means that prices should not increase significantly (inflation), and an ongoing period of falling prices (deflation) should be avoided. Long periods of excessive inflation or deflation have negative effects on the economy. While stable prices help ensure that the economy grows, jobs are secure and people can feel confident that the money in their pocket tomorrow will be worth about the same as it is today.
- If the prices of many items that people buy rise, they lose purchasing power. In other words, the money people have – their incomes and savings – isn't buying as much as it used to. This can lead to a spiral of price increases.
- The reason for this is that if it becomes more expensive, the workers may ask the employer for a wage increase. The employer may react by raising company prices to finance the requested staff wage increases. If this happens in many companies, the prices of many items will rise further and so the spiral continues.
- This makes it difficult for businesses to plan savings and investments. People may lose confidence in the currency as it loses value quickly.
- While falling prices may sound good to the consumer, ongoing and widespread falling prices across the economy that are not due to improvements in production is a problem because it can lead to a spiral of falling prices.
 - ✓ The economy will begin to slow as consumers and businesses cut back on spending and investment. It may also become more difficult to pay off any debts, such as a mortgage, which will not go down even though income may go down.
 - ✓ The same applies to public finances. Tax revenues fall because revenues and expenditures fall, but the national debt will still have to be paid. As a result, public spending on infrastructure and health care, for example, may need to be reduced. Therefore, the negative consequences of deflation are felt by everyone.

Price stability in an economy means that the general level of prices in an economy does not change much over time. In other words, prices neither rise nor fall; there is no significant degree of inflation or deflation. The term monetary policy refers to the decisions the government makes

⁴ Why are stable prices important? - European Central Bank, (2022), <https://www.ecb.europa.eu> › s.

regarding interest rates and the money supply in an economy. Monetary policy can be used to try to keep prices stable. In the EU, the European Central Bank determines the monetary policy:⁵

- The general objective of monetary policy is to help the economy of the EU countries to reach or maintain monetary equilibrium. An economy is in monetary equilibrium when the quantity of money demanded equals the quantity of money supplied. The price level where the supply of money equals the demand for it is the equilibrium price, which tends to be stable unless some external factor changes demand or supply. In other words, prices will be stable when people have no more money or less money than they have
- The European Central Bank may attempt to control inflation or deflation by engaging in open market operations. In open market operations, the bank buys or sells government securities in the open market to change the growth rate of the money supply. A change in the money supply affects the general price level.
- Monetary policy can be used to increase or decrease the money supply. As the money supply shrinks, interest rates will rise; and as the money supply increases, interest rates will decrease. In this way, the ECB can indirectly influence interest rates. However, the ECB also has more direct, albeit less effective, means of influencing interest rates which can also influence the price level.

As inflation rises across the eurozone, the ECB is under pressure to hit back with monetary policy tools, the most important of which is the key interest rate, which affects the cost of loans private banks make to businesses and private households:⁶

- With higher interest rates, investment becomes more expensive, reducing demand in the overall economy, which should reduce pressure on prices. In the current circumstances, where a lack of supply mainly drives prices, the effectiveness of this mechanism is somewhat limited.
- The increase in interest rates should also signal to citizens and companies that the central bank is serious about the fight against inflation, which aims to influence expectations for further inflation.
- The ECB is under increasing pressure as higher interest rates could contribute to an economic downturn, which is still expected due to the energy crisis.
 - ✓ More Eurozone countries are heading towards a situation where economic activity stagnates or declines, but inflation remains high, which poses challenges for central banks and finance ministries.
 - ✓ Rising interest rates also make it harder for governments to borrow money to financially support citizens or invest in, for example, energy infrastructure, which could help ease some of the supply problems that are driving up prices. of energy.
 - ✓ In the current state of uncertainty, with the likelihood of a recession looming much higher on the horizon and the likelihood of it increasing, everyone has to do their job. And the job of the ECB is price stability.

⁵ Price Stability in Monetary Policy: Definition & Overview - Study.com, (2021), <https://study.com › academy › lesson › price-stability-in->

⁶ Packroff, J., (2022), ECB hikes interest rates, insists on price stability mandate, (2022), <https://www.euractiv.com › e.>

3. Price stability in the Eurosystem.

The primary objective of the ECB's monetary policy is to maintain price stability. This means that inflation - the rate at which the prices of goods and services change over time - remains low, stable and predictable.⁷

- To help keep prices stable, the ECB needs to have the right tools at its disposal. Interest rates are the primary instrument used by the ECB for monetary policy. In recent years the ECB has added new instruments to its toolbox in response to major changes and major shocks in the economy that have made its task of maintaining price stability more challenging.
- The objectives include balanced economic growth, a highly competitive social market economy aimed at full employment and social progress, and a high level of protection and improvement of the quality of the environment – without violating the objective of price stability.
- The ECB contributes to the smooth running of the policies implemented by the competent authorities in connection with the prudential supervision of credit institutions and the stability of the financial system.
- The ECB acts in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources.
- The primary objective of the Eurosystem is to maintain price stability. This is the key provision of the monetary policy chapter of the EC Treaty. By focusing on the ECB's monetary policy it incorporates modern economic thinking on the role, scope and limits of monetary policy and emphasizes the institutional and organizational set-up of central banking in the union:
- First, decades of practical experience and a large number of economic studies suggest that monetary policy will mostly contribute to improving economic perspectives and raising the standard of living of citizens by maintaining price stability in a permanent way.
- Second, maintaining stable prices is the only viable goal for single monetary policy over the medium term. On the contrary, apart from the positive impact of price stability, monetary policy has no room for achieving a permanent impact on real variables. The Eurosystem is required to act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources.

Defining price stability

Price stability is when there are no large fluctuations in the prices of goods for general consumption. While it is important to note that the law of supply and demand will always result in some fluctuations as market dynamics change, a stable economy sees those fluctuations move within a normal range:⁸

- One of the most important aspects of a well-functioning economy is understanding the value of the money you have. Extreme fluctuations change the value of money and make purchasing and pricing decisions difficult. These fluctuations can be of two types: inflation, where prices rise, and deflation, where prices fall.
- When prices rise drastically, the purchasing power of the individual decreases. When that happens, consumers become more frugal. The resulting drop in demand has an impact on what companies can get away with and can impact revenue.
- It may seem that deflation is good for business, because inflation is bad. This is not the case. When consumers notice a rapid drop in prices, they often refrain from purchasing non-essential

⁷ Introduction - European Central Bank, (2022), <https://www.ecb.europa.eu> › i.

⁸ What is price stability & why is it important? [+examples], (2022), <https://www.profitwell.com> ›

items based on expectations that prices will be lower. So deflation can also cause demand to fall.

- Changes in monetary policy always affect prices with a significant time lag, and the magnitude of the eventual impact is uncertain. This implies that monetary policy cannot compensate for all unexpected shocks to the price level in a short period of time. Therefore, some short-term inflation volatility is inevitable. There are three main reasons for publishing a quantitative definition of price stability:
 - ✓ By clarifying the objectives of monetary policy, the definition helps make monetary policy more transparent.
 - ✓ The quantitative definition provides a benchmark against which the public can hold the ECB accountable. As deviations of price movements from price stability can be easily identified by citizens, the ECB must explain how price stability will be restored within an acceptable period of time.
 - ✓ The definition provides guidance to the public for forming expectations for the future development of prices. Stabilizing long-term inflationary expectations in accordance with price stability facilitates the task of monetary policy and improves its effectiveness.

Benefits of price stability

The goal of price stability refers to the general level of prices in the economy and implies avoiding inflation and deflation. Price stability contributes in several ways to achieving high levels of economic activity and employment:

- ✓ Price stability makes it easier for people to recognize changes in relative prices because such changes are not masked by fluctuations in the overall price level. This enables firms and consumers to make better informed decisions about consumption and investment. This in turn allows the market to allocate resources more efficiently. By helping the market direct resources to where they can be used most productively, price stability increases the productive potential of the economy.
- ✓ If investors can be sure that prices will remain stable in the future, they will not require an "inflation risk premium" to compensate for the risks associated with holding nominal assets over the longer term. By reducing such risk in the real interest rate, monetary policy can contribute to the allocative efficiency of the capital market, thereby increasing investment incentives. This in turn encourages economic prosperity.
- ✓ When price stability is reliably maintained, individuals and firms are less likely to divert resources from productive uses to inflation protection. For example, in a high inflation environment there is an incentive to stockpile real goods because they retain their value better than money or some financial assets in such circumstances. However, stockpiling is not an efficient investment decision, as it hinders economic growth.
- ✓ Tax and social systems can create incentives that distort economic behavior. In most cases, these disorders are exacerbated by inflation or deflation. Price stability eliminates the real economic costs that are imposed when inflation exacerbates the distortions of tax and social security systems.
- ✓ Price stability prevents the substantial and arbitrary redistribution of wealth and income that results in both inflationary and deflationary environments. Price stability helps maintain social cohesion and stability.

Businesses, and the economy in general, benefit when price fluctuations are kept to a minimum.⁹

⁹ What is price stability & why is it important? [+examples], (2022), <https://www.profitwell.com> ›

- Price Transparency - Prices will always change. But with price stability, consumers will be able to recognize when a particular good rises and falls in price and make more informed decisions about their purchases. When everything moves in price, it becomes harder for consumers to adjust. Clearer price developments associated with greater price stability reduce consumer hesitation.
- Avoids random redistribution of wealth - When prices change beyond the typical forces of supply and demand, there are winners and losers who have little control over their circumstances. An earlier example of how pandemic inflation hit the construction industry particularly hard illustrates how incomes can fluctuate disproportionately.
- Low Risk Premium - Another example from above illustrates this example. When the housing market is affected by inflation, it will have an impact on the number of people who are willing to take investment risk. This slowdown in investment also applies to the business sector, resulting in lower economic growth than would occur under more stable prices.
- Reduced unproductive investment activities - The risk premium calculation mentioned above certainly affects how investors behave and results in them making less valuable investments. However, attempts to overcome inflation or deflation can have the opposite effect. For example, a company may buy more inventory than it needs to avoid paying more later.

4. Risks to price stability in the monetary policy of the ECB

To achieve its price stability objective and improve the transmission of monetary policy, the ECB communicates its assessment of the balance of risks to price stability and growth:¹⁰

- The decline in economic activity puts downward pressure on prices beyond the short-term impact of falling commodity prices. This leads to concerns that the Eurozone may enter a situation that leads to a sustained and broad decline in the aggregate price level, i.e. deflation. The European Central Bank (ECB) responded to the unfolding events by rapidly cutting its key interest rates to historically low levels in order to support aggregate demand and prevent further loss of confidence.
- Forecasts are a central element in the thinking of monetary policy makers regarding the outlook for the economy and the calibration of the monetary policy stance. However, accurate forecasts fail to convey the great uncertainty related to unforeseen events and developments during the forecast horizon. Baseline forecasts include a wider range of data and encompass different models and perspectives.
- The ECB also implemented a number of non-standard monetary policy measures, including the provision of unrestricted liquidity to the banking system, to maintain financial intermediation and maintain the availability of credit to the private sector.

Risks to financial stability in the Eurozone have increased amid rising energy prices, rising inflation and low economic growth. At the same time, financial conditions have tightened as central banks act to rein in inflation:¹¹

- People and companies are already feeling the impact of rising inflation and slowing economic activity. The assessment is that risks to financial stability have increased, while a technical recession in the Eurozone has become more likely.

¹⁰ Risks to price stability, the zero lower bound and forward Guidance, (2023), <https://www.ecb.europa.eu/scpwps/ecbwp1582>,

¹¹ ECB Financial Stability Review shows risks increasing as economic and financial conditions worsen, (2022), <https://www.ecb.europa.eu>

- These recent developments increase the vulnerability of highly indebted households, firms and governments. They also increase financial market stresses and test the resilience of investment funds. Moreover, all of these vulnerabilities could spread simultaneously, potentially reinforcing each other.
- Corporate sector challenges have grown amid higher energy and other input costs, with profits expected to decline as funding costs rise. If the outlook worsens further, an increase in the frequency of corporate liabilities cannot be ruled out, especially among energy-intensive firms.
- Inflation, as well as rising gas and electricity bills, also affects households, reducing their purchasing power and potentially reducing their ability to repay loans. Lower-income households, which generally spend more of their income on energy and food, are particularly affected.
- As firms and households find it increasingly challenging to service their debts, banks could face higher credit losses in the medium term. Although the banking sector has recently seen a recovery in profitability as interest rates rise, there are initial signs of deterioration in asset quality, which may require higher reserves.
- Many governments provide fiscal support to firms and households to cushion the impact of rising energy prices. However, high post-pandemic levels of government debt, together with tighter financing conditions, limit the scope for fiscal expansionary measures that do not pose risks to debt sustainability. Support should therefore be temporary and targeted at the most affected.
- Uncertainty about the outlook for inflation and interest rates has increased the risk of asset price misalignment in financial markets, despite recent corrections. Many investment funds remain highly exposed to additional valuation and credit losses. Those with large structural liquidity mismatches and low cash buffers are particularly vulnerable to market dislocations and funding outflows. Reduced liquidity in some financial markets can also present challenges for adjusting portfolios or raising funds. It also increases the risk of unexpectedly large margin calls, which could exacerbate adverse market dynamics if funds are forced to sell assets to meet them.
- Overall, the euro area banking system is well placed to withstand many risks, in part due to regulatory and prudential policy reforms over the past decade. Given the worsening economic and financial outlook, targeted macroprudential policies, such as capital buffers, can help further strengthen the resilience of the financial system.
- Persistent vulnerabilities and risks in the non-banking financial sector require close attention from relevant supervisors. Urgent progress in regulatory frameworks is needed to strengthen the resilience of the sector, particularly to address liquidity and leverage mismatches.

5. The impact of climate change and climate policy on the ECB's price stability objective

The ECB will incorporate climate change considerations into its new monetary policy strategy. To this end, the ECB has drawn up an action plan setting out adjustments to macroeconomic modeling and statistics to gain a better understanding of the impact of climate change on the economy and the financial sector. Furthermore, the ECB will explicitly take into account climate change risks inherent in its financial market operations, such as corporate bond purchases. The

ECB will also reveal the climate change risks it is exposed to. These measures send an important signal for financial market participants to follow suit.¹²

- Governments have primary responsibility for climate policy. To meet this responsibility, they have instruments such as taxes on greenhouse gas emissions and climate investment schemes at their disposal. Governments are also increasingly acting on climate change, driven by initiatives such as the European Union's Green Deal. Because of their impact on the economy and the financial system, climate change and climate policy are also relevant to the mandate of central banks.
- Climate change and climate policy affect the ECB's goal of price stability because both can affect inflation. Prices of goods and services may fluctuate more strongly due to economic shocks resulting from the impact of climate change such as droughts or floods. Governments' climate policies, particularly emissions taxes, also generally affect price levels. In a scenario where governments are forced to sharply increase emissions taxes, for example because they were initially too slow to react, prices could rise significantly. Such effects on inflation are uncertain, but central banks must have these risks on their radar because of their mandate for price stability. The ECB is therefore adapting its macroeconomic models and statistics to gain a better understanding of the impact of climate change on the economy and the financial sector.
- Adjustments to asset purchase policy based on climate criteria:
 - ✓ The ECB will also take into account climate change risks inherent in its financial market operations. Asset purchase programs are a key tool for monetary policy in this regard. The action plan considers how to adjust the allocation of procurement under the Corporate Sector Procurement Program (CSPP), based on climate criteria. Based on these criteria, the ECB can monitor companies' commitment and compliance with EU legislation in the implementation of the Paris Agreement.
 - ✓ The amount of bonds the ECB currently buys is still based on the outstanding amount of debt of non-financial corporations on the capital market. Because emissions-intensive corporations are large and have significant recourse to debt financing, they are also a relatively large component of the CSPP. As a result, in macroeconomic terms, the CSPP does not contribute to the optimal allocation of capital in the economy.
- Risk control measures:
 - ✓ The action plan also contains specific measures for incorporating climate considerations into the ECB's risk control measures. Climate change has consequences on the value and risk profile of assets held on the central bank's balance sheet. Climate shocks can lead to write-downs of government and corporate bonds in monetary policy portfolios and therefore can affect central bank balance sheets. In addition, central banks must consider climate change and transition risks for the collateral provided by the banks they lend to. Ultimately, the credit quality of that collateral may deteriorate if these risks materialize.
 - ✓ According to the action plan, the ECB will disclose the climate risks to which it is exposed, primarily for corporate bonds within the framework of the CSPP and its investment portfolios. In addition, the ECB will make climate-related reporting a prerequisite for the participation of financial institutions in monetary operations and for the qualification to purchase and eligibility (as collateral) of assets. The ECB is also studying the possibility of incorporating climate change risks into the collateral framework, for example by applying haircuts to the valuation of collateral that is aligned with these risks. The ECB will also

¹² ECB includes climate change in monetary policy strategy, (2021), <https://www.dnb.nl> ›

integrate climate risks into its own risk management framework by performing climate stress tests.

Dealing with climate change is a global challenge and a policy priority for the European Union. While governments and parliaments have the primary responsibility to act on climate change, within its mandate, the ECB recognizes the need to further integrate climate considerations into its policy framework:¹³

- Climate change and the transition to a more sustainable economy affect the outlook for price stability through their impact on macroeconomic indicators such as inflation, output, employment, interest rates, investment and productivity; financial stability; and the transmission of monetary policy. In addition, climate change and the carbon transition affect the value and risk profile of assets held on the Eurosystem's balance sheet, potentially leading to an unwanted accumulation of climate-related financial risks.
- With the action plan, the ECB increases its contribution to tackling climate change, in accordance with its obligations from the EU Treaties. The Action Plan contains measures that strengthen and extend the Eurosystem's current initiatives to better take into account climate change considerations in order to pave the way for changes in the framework for the conduct of monetary policy. The design of these measures will be consistent with the objective of price stability and should take into account the implications of climate change for the efficient allocation of resources. The recently established ECB Climate Change Center will coordinate relevant activities within the ECB, in close cooperation with the Eurosystem.
- Macroeconomic modeling and assessment of implications for the transmission of monetary policy. The ECB will accelerate the development of new models and conduct theoretical and empirical analyzes to monitor the implications of climate change and related policies for the economy, the financial system and the transmission of monetary policy through financial markets and the banking system to households and firms.

Conclusion

The objective of price stability refers to the general level of prices in the economy. This means avoiding prolonged inflation and deflation. Price stability contributes to achieving high levels of economic activity and employment by improving the transparency of the price mechanism. Under price stability, people can recognize changes in relative prices (ie, prices between different goods), without being confused by changes in the overall price level. This enables them to make well-informed decisions about consumption and investment and to allocate resources more efficiently.

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