

ECB: PATIENCE REQUIRED

The outcome of the ECB meeting was eagerly awaited considering the latest inflation data, the strengthening of the euro and the Federal Reserve's new strategy of targeting average inflation. The implicit message from the ECB President's press conference was "be patient" on the three areas of concern. Inflation is projected to pick up whilst staying well below the target, the euro exchange rate is being closely monitored and the sheer number of strategy review workstreams implies it will take quite some time before we learn about the outcome in terms of the inflation objective.

In the run-up to the ECB meeting, three topics were top-of-mind: the recent inflation numbers, the strengthening of the euro and the reaction to the Federal Reserve's new strategy of targeting average inflation. The implicit message from the ECB President's press conference was "be patient" on the three areas of concern. Given the recent decline of core inflation and the euro appreciation, the upward revision of staff projection for 2021 and 2022 was, at first glance, surprising.¹ According to the ECB, "the downward impact of the appreciation of the euro effective exchange rate is more than offset by the combined upward impact of the reversal of the German VAT cut in 2021, indirect effects of stronger oil prices as well as higher activity and lower unemployment projections." Referring to the influence of activity and unemployment is somewhat puzzling considering that their projected values have not changed for 2021 and 2022 compared to the June projection.² It shows the complexity of interpreting longer-term inflation forecasts given delayed effects of policy measures and an interplay of sometimes conflicting forces. More important than the upward revision is the fact that (core) inflation is expected to remain far too low compared to the ECB's objective. A lot of patience will be needed to get there. It also implies that the current monetary policy stance will have to be maintained for a long time.

Against the inflation background, the market was eager to hear the comments of Christine Lagarde on the euro. For any central banker, talking about the exchange rate is much like handling a hot potato. When the currency is weakening in a slow growth environment, enthusiasm should be tempered. Otherwise there is the risk of being blamed of pursuing a beggar-thy-neighbour policy or even starting a currency war. An appreciation in a slow growth/low inflation situation doesn't make communication easier. Expressing serious concern triggers expectations of imminent policy action, without guarantee of being successful. Showing a lack of interest can weigh on the credibility of an inflation-targeting central bank. The ECB President did the strict minimum: developments of the euro exchange rate are being carefully monitored. Here again, patience is required from those who count on more outspoken communication or even action. Eventually, it could lead to an increase in the asset purchases. In the meantime, the Governing Council's wait-and-see attitude is understandable. After all, the euro strengthening is to a large degree related to the warm welcome of the

1. In the previous projections (June 2020) inflation excluding energy and food was expected at 0.7% in 2021 and 0.9% 2022. The new projections are respectively 0.9% and 1.1%. Source: ECB staff macroeconomic projections for the euro area, September 2020

2. Moreover, unit labour costs have been revised downwards for 2021 (2022 was left unchanged)

EU recovery plan. Moreover, since August, the exchange rate versus the dollar has essentially been moving sideways.

The strategy review seems to be the area where most patience will be required from analysts and investors. Understandably, Christine Lagarde gave no indication on the possible outcome nor on whether the Fed's strategy would be a source of inspiration. On the latter's point she only said that the changes had been 'noted'. Rather, she provided an exhaustive list of all the ECB workstreams³. The insistence that they all interact suggests that all aspects of the outcome of the review will be communicated at the very end of the process. For anybody counting on an accelerated announcement of a change in the objective or in the calculation of inflation, the message is not to hold your breath. It will take time, a lot of time.

William De Vijlder

ECB ECONOMIC PROJECTIONS

	SEPTEMBER 2020			DIFFERENCE VERSUS JUNE PROJECTIONS		
	2020	2021	2022	2020	2021	2022
Real GDP growth	-8.0	5.0	3.2	0.7	-0.2	-0.1
HICP excluding energy and food	0.8	0.9	1.1	0.0	0.2	0.2
Unemployment rate	8.5	9.5	8.8	-1.3	-0.6	-0.3
Unit labour costs	4.3	-1.7	0.1	-0.1	-0.2	0.0

SOURCE: ECB

3. Inflation measurement, price stability objective, Euro system modelling, digitalisation and the impact on monetary policy, climate change, financial stability and macroprudential policies, non-bank financial intermediation, communication and the interaction between monetary policy and fiscal policies.

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