

The ECB is still worried about the weakness of inflation

By [Christophe Blot](#), [Jérôme Creel](#) and [Paul Hubert](#)

The President of the European Central Bank, Mario Draghi, recently [announced](#) that the increase in the ECB's key interest rate would come "well past" the end of the massive purchases of bonds (scheduled for September 2018), mainly issued by the euro zone countries, and at a "measured pace". The increase in the key rate could therefore occur in mid-2019, a few weeks before the transfer of power between Mario Draghi and his successor.

In his quarterly hearing with MEPs, Mario Draghi proved to be cautious about the intensity and sustainability of the economic recovery [\[1\]](#). Listening to him, the euro zone has not necessarily closed its output gap (actual GDP would have remained below its potential) despite the recovery in recent quarters. This is not the time to change the direction of monetary policy at the risk of weakening the recovery. It is also undeniable that the effects of the recovery are only materializing slowly and gradually in wage increases, which partly explains why the euro zone inflation rate remains below its mid-term target.

The ECB President has also been confident that companies are gradually anchoring their price (and wage) expectations on the ECB's inflation target of 2% per year. Mario Draghi also appeared very confident in the effectiveness of monetary policy. He announced that the measures undertaken since 2014 would contribute to a (cumulative) increase of 2 percentage points, respectively in real growth and inflation between 2016 and 2019.

If the ECB's forecast of inflation back to its target in 2019 is contradicted by [Hasenzagl et al. \(2018\)](#), we find these same determinants of European inflation. In a [recent study](#), we also show that the two main determinants of inflation in the euro area are inflation expectations and wage growth. Without anchoring the former on the medium-term target of the ECB and without a second-round effect of monetary policy on wages, inflation will not return to its target in the short term. Structural reforms may have increased potential GDP, as argued by Mario Draghi, but they have so far more certainly weighed on wage and price developments.

[\[1\]](#) Once a quarter, a monetary dialogue is organized between the President of the ECB and the members of the Monetary Affairs Committee of the European Parliament. This dialogue allows the President of the ECB to explain the direction of monetary policy in the euro area and to express his point of view on topics defined upstream. Une fois par trimestre un dialogue monétaire est organisé entre le Président de la BCE et les membres de la Commission des Affaires monétaires du Parlement européen. Ce dialogue permet au Président de la BCE d'expliquer l'orientation de la politique monétaire dans la zone euro et d'exprimer son point de vue sur des sujets définis en amont.

The ECB is extending its QE

programme but mixes up its communications

By [Paul Hubert](#)

On Thursday, March 10, after the meeting of its Governing Council, the European Central Bank (ECB) announced a series of additional measures for the quantitative easing of monetary policy. The aim is to prevent the onset of deflation and to boost growth in the euro zone. The key innovation lies in the measure for bank financing at negative rates. While the measures were well received by the markets at the time of the announcement, a lapse in Mario Draghi's communications during the press conference following the Board of Governors meeting greatly undercut some of the impact expected from the decisions taken.

What decisions were taken?

- The three key rates set by the ECB were lowered. The main refinancing rate went down from 0.05% to 0%, while the marginal lending rate was cut from 0.30% to 0.25%. Finally, the [deposit facility rate](#), which compensates the excess reserves that banks hold on the ECB's balance sheets, is down from -0.30% to -0.40%. It thus now [costs a bank more](#) to have cash on the ECB's balance sheet.
- [Quantitative easing](#) (QE) has been extended in terms of its scale – securities purchases rose from €60 bn to €80 bn per month – but especially in terms of the types of securities eligible for purchase. While heretofore the ECB has bought government bonds (sovereign and/or local authority bonds), it will now buy high-quality corporate bonds, based on rating agency criteria. This measure is a direct response to the drying up of the supply of government securities and is expected to directly influence the conditions for corporations

active on the bond markets.

– The most significant innovation concerns the [new Targeted Longer-Term Refinancing Operations](#) (TLTRO), which are intended to reboot the channels of bank lending and to provide financing to banks *on the condition that* they finance the real economy. These loans to banks will be at a zero or even negative rate, based on various [criteria](#), including the amount of loans that the banks provide to households and businesses. In other words, the ECB will pay banks meeting these criteria, so that they in turn lend.

What is the expected impact?

The effect to be expected from these measures depends on the situation of the credit market. Numerous [studies](#) show that in normal times these measures have a positive effect on the economy. However, this holds true only if it is the *supply* of credit that is currently constricted in the euro zone. Conversely, if the problem lies in the demand for credit on the part of consumers and businesses who have poor prospects in terms of income and profits, then these measures will have little effect. In granting banks such favourable conditions, it is easy to imagine that the ECB is betting on increasing the solvent demand for credit, that is to say, that the ECB is providing banks with strong incentives to lend to households and individuals that might have appeared non-creditworthy in previous conditions. Another expected effect of the lower deposit facility rates and the increase in QE will pass through the channel of a lower exchange rate for the euro, which will promote euro zone exports and increase imported inflation, and therefore overall inflation in the euro zone. This channel is potentially even more important given that the US Federal Reserve has initiated a period of monetary tightening.

Nevertheless, a more relevant economic policy would be to make use of fiscal policy to support demand, especially as the

conditions for State financing are at historically low levels: the French state in 2016 is earning money from issuing [debt of less than 4 years](#). Monetary policy would then have all the more effect.

Why announce that there's no manoeuvring room left?

At the press conference following the meeting of the Governing Council, Mario Draghi announced that the ECB didn't expect "to reduce rates further", which had the effect of completely changing the financial markets' interpretation of the decisions announced just before that. While the aim of these very expansionary decisions is to further ease monetary and financial conditions and to lower the exchange rate for the euro, the announcement that future changes in the ECB's monetary policy could only be in a more restrictive direction transformed investor expectations.

As one of the main channels for the transmission of monetary policy involves expectations, several studies conducted on data from the US [\[1\]](#), Britain [\[2\]](#) and the euro zone [\[3\]](#) show that a central bank's communications need to be consistent with its decisions, otherwise the impact expected from monetary policy will be limited. This is called the "signal effect" of monetary policy. Mario Draghi's short statement is one such example. The following graph shows the exchange rate of the euro vis-à-vis the dollar during the course of 10 March. The sharp drop at mid-day corresponds to the publication of the decisions taken by the Board of Governors, while the equally sharp rise corresponds to the contradictory message issued a few minutes later at the press conference. We thus see that as a series of highly expansionary measures – one of whose goals is to push down the euro – was announced, the euro eventually rose vis-à-vis the US dollar as if restricting measures had been put in place.

This does not necessarily mean that these decisions will have no effect, but that some of the effect will be lessened, or

even disappear. [Some transmission channels other than the signal effect](#) remain operative. While the exchange rate channel has now been limited by the restrictive effect generated by the channel of expectations, we will see in the weeks and months to come whether capital movements induced by the decisions taken will have the effect expected on the euro exchange rate.

Figure. Euro-dollar exchange rate, day of 10 March 2016.



Source: Boursorama.

[1] Hubert, Paul (2015), "[The Influence and Policy Signalling Role of FOMC Forecasts](#)", *Oxford Bulletin of Economics and Statistics*, 77(5), 655-680.

[2] Hubert, Paul, and Becky Maule (2016), "[Policy and Macro Signals as Inputs to Inflation Expectation Formation](#)", *Bank of England Staff Working Paper*, No. 581.

[3] Hubert, Paul (2015), "[ECB Projections as a Tool for Understanding Policy Decisions](#)", *Journal of Forecasting*, 34(7), 574-587, or Hubert, Paul (2016), "[Disentangling Qualitative and Quantitative Central Bank Influence](#)", *OFCE Working Paper*, No. 2014-23.