ECB Minutes: Inflation confusion

The minutes of the ECB's March meeting reveal an improved confidence in the recovery, but at the same point a growing uneasiness regarding the stubbornly low inflation

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Even though the Governing Council still sees some downward risks to the economic expansion emanating from trade protectionism, Brexit and volatility on financial markets, recent economic data were considered strong enough to remove the easing bias attached to the Asset Purchase Programme.

However, when assessing the inflation outlook, the Governing Council seemed to suffer from a bout of confusion. On the one hand, it expressed high hopes that on the back of the improving growth picture would lead to an adjustment of the path of inflation towards the Governing Council's inflation aim. On the other hand, it noted the lack of convincing signs of a sustained upward trend in measures of underlying inflation. Moreover, during the Council's discussion several arguments were put forward that could lead to a continuing inflation undershoot:

1. The view was widely shared that there was considerable measurement uncertainty about the degree of slack remaining in the labour market and in the economy as a whole. It was put forward that there could be more spare capacity in the economy than was currently implied by traditional measures.

2. It was argued that hysteresis in the labour market (a phenomenon where unemployed workers are no longer fit for the labour market because of a lack of skills, thereby reducing the amount of slack) might be reversed in a strong economic recovery.
3. It was remarked that recent movements in the euro exchange rate seemed to relate more to relative monetary policy shocks, including communication, and less to improvements in the macroeconomic outlook for the euro area. This suggested that the exchange rate appreciation could be expected to have a more negative impact on inflation. In addition, even though the effect of the euro's appreciation on inflation had been limited so far, the pass-through could be stronger if the shocks turned out to be permanent.

The Governing Council therefore concluded that remaining uncertainties and muted underlying inflation pressures called for caution and underlined the need to maintain the prevailing policy posture of prudence, patience and persistence. This suggested that the monetary policy decisions taken at the meeting in late October 2017 on net asset purchases, reinvestments and policy interest rates had to be reconfirmed.

Bottom line: even though the ECB removed the easing bias attached to the QE programme, it is well aware that inflation threatens to remain subdued for longer than expected. That means that monetary policy will have to stay extremely loose for some time to come. After the meeting both Jens Weidmann and Klaas Knot, two of the more hawkish members, declared that they felt comfortable with a first rate hike in the second quarter of 2019. But these are the hawks! The minutes strengthen us in our belief that June 2019 will be the earliest possible date for a rate hike and chances are high that it will be even later.

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