

ECB: Keeping a 'free hand' in a world of uncertainty

The just-released minutes of the ECB's September meeting suggest that the ECB is more alarmed about inflation than we originally thought



ECB President, Christine Lagarde at the International Finance Forum in Paris

Remember that the ECB's September meeting was the one which disappointed financial markets regarding the communication on the strengthening of the euro and the potential impact on the ECB's monetary policy. The September meeting was also that which was followed by an entire army of speeches, blog entries and interviews in the days after the news conference, probably intended to get expectations back under control.

The highlights from the minutes

So the minutes of this September meeting suggest that the ECB was actually more concerned about the inflation trajectory and the euro than anticipated by market participants after the news conference.

Here are some highlights from those minutes:

- Uncertainty has once again increased. The word '*uncertainty*' appears 23 times in the

minutes.

- There was some comfort for the ECB as longer-term inflation expectations had increased since their mid-March lows. Still, they remained low against historic comparisons.
- The ECB remarked several times that the current inflation outlook was highly dependent on the large amount of fiscal and monetary stimulus, suggesting that this outlook was far from materialising. This was also reflected in the statement that “the argument was made that the inflation outlook in the September staff projections appeared too optimistic”.
- As for the strengthening of the euro, many ECB members referred to the openness of the eurozone and the fact that a currency appreciation was not only a risk to inflation but also to growth. Other comments like “*it was suggested that it was the pace of the euro’s appreciation, rather than the level of the exchange rate, that could become a concern*” show that the ECB is paying close attention to the exchange rate.
- While the ECB’s Christine Lagarde didn’t mention “*complacency*” at the press conference, ECB chief economist Philip Lane did in his blog entry the day after the news conference. “*There was no room for complacency*” returned today in the minutes.
- The ECB’s willingness or at least openness to do more was reflected in the view that “*the case was made for keeping a “free hand” in view of the elevated uncertainty, underpinning the need to carefully assess all incoming information, including the euro exchange rate, and to maintain flexibility in taking appropriate policy action if and when needed.*”

The new old dissent

Looking ahead, after months of speaking with one voice, the old controversies between hawks and doves have returned centre stage. With dropping inflation rates, increased uncertainty and higher unemployment, the risk of outright deflation has increased; at least in the eyes of some. This brings back memories of 2014 and a return of the good old camps from the Draghi era.

This brings back memories of 2014

The camp of the hawks, who argue that negative inflation is only temporary and will reverse in the course of 2021, hence doing nothing is the preferred option. And there is the camp of the doves, arguing that this is like 2014 and negative inflation combined with uncertainty and increasing unemployment is a real danger, hence more action is needed. In an interview with the German *Börsen-Zeitung*, the Bundesbank president Jens Weidmann today warned against the expectation that the ECB always had to add monetary stimulus.

The doves should win this fight

In our view, the doves should win this fight, also given that there is a risk of a double-dip recession in the eurozone towards the end of the year; something that is not included in the ECB’s base projections. As a result, we expect the ECB to increase QE, focusing on PSPP, the public sector purchase programme, instead of continuing PEPP, its emergency pandemic response. The ratio for such a shift would be that PEPP was aimed at bringing inflation expectations and projections back to their pre-Covid-19 levels, while in the second stage PSPP should be used to bring these

expectations and projections from their pre-Covid-19 levels in line with the ECB's own aim. The December meeting should be the next important showdown.

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