Central Banks / Global Economy

A major step for the ECB

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Last Thursday, the ECB maintained interest rates, but has prepared the ground for changes in September in response to the fact that inflation and its expectations have been below target for a long time.

With interest rates in negative (-0.40%) and with a fattened balance after the purchase of assets of EUR 2.5 trillion, the ECB is inclined to step up the little margin that seems to remain on this side. An additional cut in interest rates will most likely be made in September, which will be accompanied by some kind of measure to mitigate some of the adverse effects of negative rates, which is already a sign that this situation will endure for a while. Along with this, it will also modify the forward guidance on when interest rates could rise, eliminating the calendar-based leg and making it clear that rate increases will not occur if they are not comfortable with inflation again. On the other hand, possible formulas will be explored if the asset purchase program needs to be resumed. This option is probably reserved for a further deterioration of the environment (for example, in the event of materialization of risks such as a no-deal Brexit or if protectionist threats occur), in which case other policies would also be needed.

However, beyond squeezing these instruments, whose marginal effect is increasingly questioned, a change is anticipated that, from a monetary and medium-term point of view, may be of greater importance: the (re)formulation of the inflation target. How is price stability defined in the eurozone? In 1998, the ECB Governing Council defined it as inflation within the range of 0–2% in the medium term. In 2003, the Council clarified that, within this range, inflation should be "below but close to 2%." However, the objective, thus expressed, leads to the thought that 2% is a ceiling.

This has caused the ECB to open up a reflection. Everything points to the fact that the time has come to re-refine the formulation, so that asymmetry is explicit and therefore it is perceived that inflation can deviate in both directions. If so, and given that for many years the inflation rate has been below the target, the reading is that the ECB would be more flexible, it would be willing to allow inflation to exceed 2% for a long period of time. It will be revealed in September, or at the Jackson Hole annual meeting in August and, if confirmed, will be a major step for the ECB.

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