ECOWEEK

No. 17-46, 15 December 2017

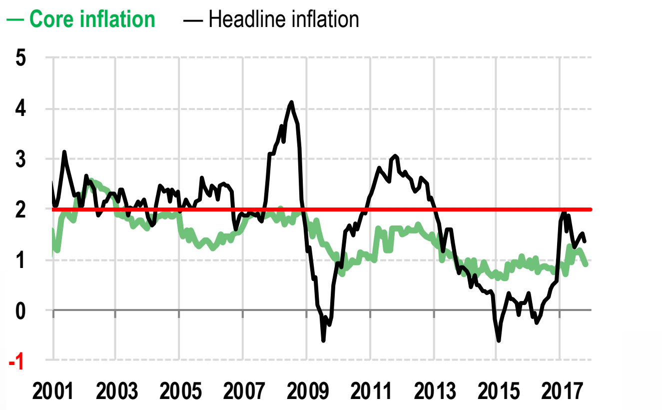
ECB forward guidance: well-intended vagueness

■ The ECB is upbeat on the growth outlook but considers that inflation remains subdued ■ Nevertheless, it still expects inflation to rise to 1.7% in 2020 ■ The refusal to label this as being sufficiently close to its objective reflects a cautious attitude as well as an effort of being vague for a good reason

Mario Draghi's press conference yesterday has added a word to the list of important yet vague words in ECB speak: *"close"*. Is the projection of 1.7% inflation in 2020 sufficiently close to the objective of *"close to but below 2%"*? Unsurprisingly the answer to the journalist's thoughtful question was not clear and the ECB president has every interest in being vague. Firstly, as he explained so eloquently, it depends on the environment: is such a level of inflation sustainable in the absence of the current accommodative stance? Secondly, a point which he didn't mention, a central banker doesn't want to be locked-in: labelling 1.7% as *"close enough"* today would cause market anticipation of policy change well before this level would be reached thereby weighing on the effectiveness of the current policy in supporting growth and inflation dynamics.

For the very same reason that other key word is not defined either: *"well past"*. Current policy rates will be maintained well past the end of QE. The refusal to provide a definition is again based on the idea of avoiding to tie one's hands, to precommit based on data thresholds or a specific date. Investors may feel left behind empty-handed: although risk and uncertainty generate the extra return over and above the risk-free rate they strive for, they hate uncertainty so in their dreams guidance is clear and *"close"* and *"well past"* are precisely defined. However, such a dream could end up in a nightmare: the environment might change forcing the central bank to renege on its earlier guidance. Investors would wake up with a headache and volatility would increase structurally because everybody would understand that firmly stated guidance is of little value in a world which is rife with "known unknowns". Out would go the credibility of the central bank. At the end of the day, guidance should be sufficiently clear whilst remaining…sufficiently vague. It's in the interest of the speaker (the central bank) and his audience (markets).

EUROZONE HEADLINE AND CORE INFLATION



Sources: Eurostat, BNP Paribas

William De Vijlder

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world