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EUROZONE

New ECB measures over the top

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In our view the inflation picture does not justify the ECB's renewed escalation of crisis mode. The additional loosening will do precious little for the economy. And the impact on yield and exchange rate levels is likely to be limited, given the downward adjustment prior to the decision. The risk of adverse side effects is rising, among them the danger that eurozone financial markets will again overshoot. Moreover, bond purchases and ultra-low interest rates remove the incentive to plow ahead with debt reduction.

The relatively high market expectations prior to the ECB Governing Council meeting were in part disappointed by today's decisions to extend QE and lower the deposit rate further into negative territory. Nonetheless, the trimming of the deposit rate is likely to act mainly via the exchange rate channel. The additional bond purchases shield the yield level against upward pressure from across the Atlantic caused by the looming divergence of US and eurozone monetary policy.

In our view the ECB had to date done enough, if not more than enough, to kick-start the eurozone economy and get inflation back on track towards "below but close to" 2% in the medium term. We regard the latest measures as over the top. All in all, the latest economic indicators paint an encouraging picture – i.a. industrial capacity utilization back above the long-term average, upbeat sentiment indicators (despite the attacks in Paris) and steadily falling unemployment.

In individual countries enjoying relatively strong growth – particularly Ireland, and Spain, too – it is to be feared that ECB monetary policy will be too loose for too long, possibly giving rise to a renewed boom-bust cycle. For what is more, national fiscal policy is not taking countermeasures but, as in the eurozone as a whole, is no longer tightening its belt as firmly as during the crisis.

For countries with weak growth and towering debt – first and foremost Italy – ultra-loose monetary policy might well be welcome, but whether it really helps them is doubtful. The ECB's massive intervention is distorting market signals. For instance, it is questionable whether the present Italian yield level (e.g. below 1.5% on 10y government bonds) adequately reflects the risks of a debt mountain of over 130% of GDP. Given the assistance on the consolidation front provided by a lower interest burden, as a quid pro quo debt should be being reduced more rapidly. Incentive mechanisms that generate the necessary pressure to act are missing (also for growth-enhancing structural reforms).

Given the grave negative effects of expansionary monetary policy on asset yields and the willingness of investors to entertain higher risks, we do not think that the trend in inflation as the "measure of all things" is signaling an acute need for further action. Core inflation currently stands at around 1%, a base effect will push headline inflation up towards 1% early next year. With economic growth in the eurozone on course for 1.7% in 2016 and 1.8% in 2017, eurozone inflation will continue to pick up gradually even if probably not quite reaching the ECB's objective (our forecast: 1.6% on average 2017). In our view, the inflation outlook does not warrant the ECB digging itself deeper into crisis mode.

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