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ECB

# Unnecessary rate cut

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The renewed rate cut by the ECB will have no notable impact on the economy or the level of inflation. With the negative deposit rate the ECB has needlessly moved into uncharted territory. By contrast, the new longer-term tenders are to be welcomed. The deflation debate still looks overdone and is not backed up by the latest ECB projections.

Given the ongoing recovery and fairly upbeat business suveys in the eurozone, a renewed ECB rate cut was not warranted. A rate cut of 10 basis points will have neither a notable impact on the economy, nor will it influence the current level of inflation, which is pivotal for inflation expectations. At best, psychological effects might serve to weaken the euro in the short term, as the interest-rate decisions bring no substantial changes. While the policy decision brings scant benefit, in the medium-term it will further fuel financial market risks. Investors will see this rate cut as a further signal that only risky investments can generate satisfactory returns. However, excessive risk appetite is the breeding ground for market imbalances.

The experiment with a negative deposit rate harbors more risks than potential benefits. Getting the money market to function properly again requires trust, not coercion. Signal effects might help to achieve the desired weakening of the euro. But is it really wise to deter foreign investors and encourage domestic banks to invest their money outside the eurozone?

The extension of unlimited liquidity until the end of 2016 and the announcement of two new targeted long-term refinancing operations (TLTROs) represent a far-reaching commitment by the central bank but, unlike the interest rate cut, are fundamentally positive. Such liquidity assistance makes sense and is still required as trust among the commercial banks has still not been fully restored, banks in crisis countries remain heavily reliant on central bank loans, and the remaining maturity of the three-year tenders is

now below one year. The linkage to lending affects for one thing the Achilles' heel in the transmission mechanism and at the same time prevents the funds from being channeled directly into the purchase of government bonds. However, the fact that the interest rate on the TLTROs will be fixed over the life of each operation at the rate on the Eurosystem's main refinancing operations (MROs) prevailing at the time of take-up, plus a fixed spread of 10 basis points, needs to be viewed critically. This means that banks look set to be provided with liquidity at very low rates for a long period. This reduces the incentive for banks to get their balance sheets on a sound footing.

Overall, the ECB's package of measures stems from the logic that deflationary trends currently represent a substantial risk. We still do not share this view and see the low inflation rates largely as the result of the necessary internal adjustment processes and a favorable trend in a number of world market prices. The ECB's new inflation projections still include the expectation that inflation will move back up substantially in the medium term. For this reason alone, there is no need to take a sledgehammer to crack a nut. If investor risk appetite and the hunt for returns escalate further due to the zero interest-rate policy, there is an increasing danger of setbacks on the financial markets. Paying more heed to this aspect would mean leaning against the wind. Alongside maintaining price stability, the emergence of financial market bubbles also needs to be countered. This should be the lesson of the preceding two decades. For neither the ECB nor fiscal policymakers would have anything with which to tackle a renewed crisis on the financial markets fueled by excessive risk appetite.

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