ECONOMIC RESEARCH

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EUROZONE

## Further ECB loosening not the answer

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The fact that eurozone inflation has fallen below zero and is likely to stay there for a while is no reason to step up monetary policy crisis mode yet further. The current stagnation of prices is thanks to oil and commodity price developments and not a sign of menacing deflation. The ECB should consider returning to the definition of price stability it used prior to May 2003. Moreover, the improvement on the eurozone labor market should not be overlooked. On Thursday the ECB will have to revise its forecast for the unemployment rate down significantly.

With ECB president Draghi having left little doubt in his recent statements that further loosening measures would be taken this Thursday, a further cut in the deposit rate to -0.4% and/or an expansion of the monthly bond purchasing volume to EUR 75 to 80bn is on the cards. As the latter would be substantial, there is unlikely to be any change in the time horizon to end-March 2017.

Although inflation in the eurozone has slipped below zero of late and is likely to remain stuck there in the months ahead, stepping up monetary policy crisis mode still further does not seem warranted. Low inflation is fueled first and foremost by the slide in oil prices and lower prices for imported intermediates. The eurozone economy has picked up and has become increasingly resilient (our forecast for eurozone growth this year: 1.7%).

Although, despite loose monetary policy, the ECB will clearly miss its inflation objective of “below but close to 2%” for the fourth year running in 2016, it should not keep upping the dosage of a medicine that is no longer working.

Instead, this should prompt a rethink of the ECB's inflation targeting. Defining price stability as an inflation rate between 0 and below 2%, as the ECB did until May 2003, would provide the necessary flexibility. And, in certain circumstances, temporary deviations above the medium-term goal of 2% should also be tolerated. That was also the ECB's approach in the past.

Without question, the global economic picture is marred by uncertainty at present. But the news is not all bad. For instance, the situation on the eurozone labor market is improving faster than widely expected. Eurozone unemployment has fallen of late to 10.3% (from its peak of 12.1% in the spring of 2013). We estimate that it will fall to approximately 9¾% by the end of 2016. We are now forecasting average unemployment this year of 10% – three tenths lower than just three months ago. By comparison: in the ECB projections published in December, estimated average unemployment was put at 10.5% in 2016 and 10.1% in 2017. In the new projections to be published on Thursday, these numbers will have to be revised significantly downwards.

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