ECB announces additional measures but still has more work to do

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As widely expected, the ECB loosened monetary policy further on Thursday with the deposit rate moving into negative territory for the first time in the history of major central banks. In addition, the ECB also announced new liquidity measures in order to improve the functioning of monetary policy. However, the announced measures are probably not enough to really lift inflation and push the euro lower. Despite recent improvement in leading indicators, the combination of very high unemployment and very low inflation reveals that there is still a large degree of slack in the eurozone economy. Therefore, the ECB has still more work to do.

On thursday, six months after its latest move in December last year, the ECB cut interest rates again. More spefically, the policy rate was lowered to 0.15% (from 0.25%) and the deposit rate was brought into negative territory (to -0.1%). Moreover, the ECB also announced further liquidity measures. In theory, all this should encourage commercial banks to lend more money to households and companies. With eurozone unemployment still very high (11.7%), inflation falling further (to 0.5% in May) from already very low levels, bank lending growth in negative territory and the euro uncomfortably strong, this move was anticipated and in fact long overdue. True, leading indicators throughout the eurozone have seen a welcome improvement since the summer of 2013. This may explain why the ECB has not acted sooner but all in all this is not a very convincing argument. In reality, the eurozone recovery is still fragile and the easiest part of the recovery may well lie behind us. Taking into account the latest ECB announcements, it’s far from guaranteed that inflation will move significantly higher, let alone to the ECB’s target of 2%, anytime soon and hopes that this will kickstart lending growth may prove idle. After all, in general, commercial banks are probably not willing to expand their balance sheets against the back of current regulations. Concerns reamain for several reasons. Most importantly, apart from Italy and Ireland, all countries in the periphery are now actually in or are at least flirting with deflation. Obviously, this lowflation environment threatens the still fragile recovery. And there is another important reason why the current absence of price pressures is dangerous. Indeed, low inflation or actual deflation makes it near to impossible to reduce the real debt burden of households, companies and governments throughout the periphery and even the core countries. Obviously, that is an important condition for any sustainable economic recovery in the eurozone area. Meanwhile, unemployment remains worryingly high.

All in all, the ECB probably lived up to financial market’s expectations. On the other hand, however, it’s far from certain that these measures will be enough to resolve the eurozone’s problems. The reality is that the eurozone economy, although gradually recovering, is still in fairly poor shape. Therefore, probably more action is needed. In particular with the aim of pushing the euro significantly lower from current strong levels (with EUR/USD around 1.36 at the time of writing). The ECB announced that it’s stepping up its preparatory work related to purchases in the asset backed security market but, although welcome, given the small size of the market, it’s highly doubtful whether this measure would have a meaningful impact. Further policy easing in the form of outright quantitative easing or direct intervention in the currency market could bring the euro down more sharply, further support economic activity and reduce unemployment. But for now at least, it’s still far from certain whether the ECB is really prepared to walk this path.