

INVESTMENT NOTE

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HERMES: THE ECB AIMS A BAZOOKA

By Neil Williams, Group Chief Economist:

“After three years of baby steps, Mr Draghi has today taken the giant leap forward financial markets were waiting for – but it will be no *panacea*.

By launching Eur 1.1trn in asset purchases over the 18 months starting this March and keeping the door open for more, the ECB will cement the impact of low borrowing costs, add liquidity, and, by trying to take the rug from under the euro, aim its first ‘bazooka shot’ at deflation.

This and his prior pledge to do “*whatever it takes*”, means Mr Draghi is doing a good job of addressing the *symptoms* of the crisis - escalating funding costs and, more recently, deflation. Also, his avoidance today of ‘blanket’ risk-sharing and skewing the bond purchases according to members’ capital contributions to the ECB will appeal to those worried that fiscal discipline would be thrown out of the window.

But anyone expecting the QE bazooka to quickly fix the *problem* – a monetary union still devoid of sufficient economic union – will be disappointed. Within the euro-zone, shifts in euro-members’ competitiveness are still far too disparate for that happen.

The biggest competitiveness winner with the euro is still Germany, with the other, ‘satellite’ members having suffered a net deterioration. The good news is Spain and Italy are improving strongly. But, France’s competitiveness is eroding, and even Germany’s ‘bullet proof’ status economically is now threatened by a slowing China and upheavals in Russia.

Tackling the causes of the euro-zone crisis needs years of work, and more than just QE – which, as we know from the US and UK, is a blunt instrument more likely to generate asset-price, than ‘feel-good’ demand, inflation.

Yet, without QE, some of the growth and tax benefits to Spain, Italy and others from their overdue competitiveness gains may not be maximised by a weaker euro.

The challenge is now to make sure the euro-zone does not follow Japan and let deflation take root. There, QE has been running for 16 years with little inflation impulse. The ECB’s ‘tap’ may be finally on, but, as Japan found out, QE acts like a drug: the more you use it; the more you need it. Euro-zone QE could thus be with us for many years to come.”

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