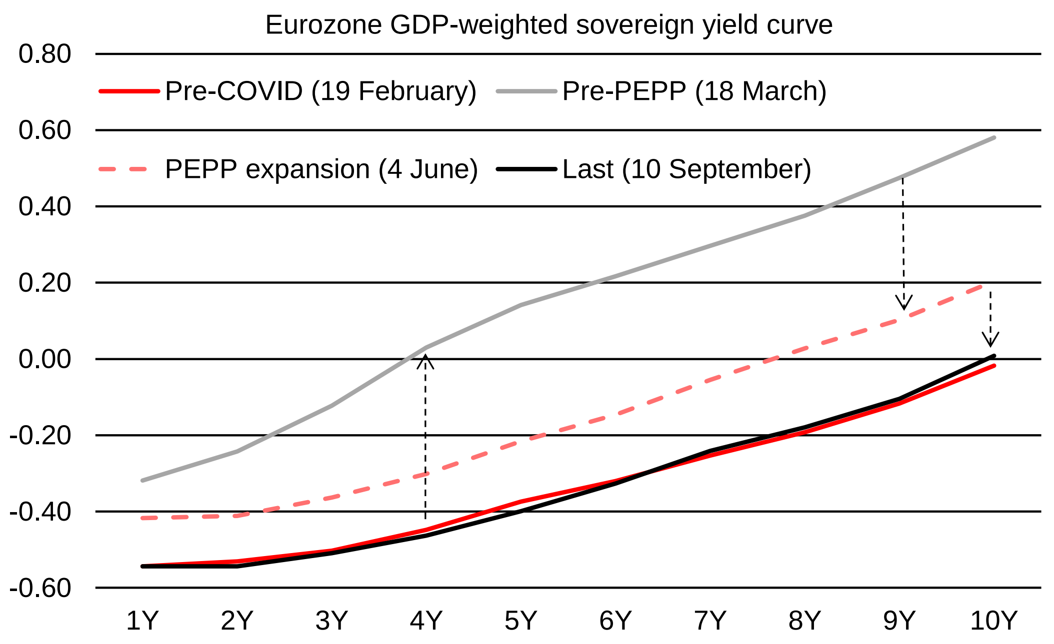
Eurozone sovereign yields back to pre-pandemic levels, but the ECB is not done



The pre-COVID date of 19 February has been used as reference by some members of the ECB's Governing Council.
Source: UniCredit Research

- Our *Chart of the Week* shows that the GDP-weighted eurozone sovereign yield curve has fallen back to the level prevailing before the pandemic. The improvement has reflected declines in yields across all countries (although BTP yields are still some 10-15bp higher in most buckets). The GDP-weighted eurozone curve is closely monitored in Frankfurt because it provides important indications on both the degree of market fragmentation and the overall monetary stance. The decline to pre-COVID levels represents an important achievement for the ECB and confirms the effectiveness of its pandemic emergency purchase program (PEPP).
- However, there are several reasons why the ECB is not anywhere close to finishing its job. First, while the curve is back to where it was before the shock, GDP is not. By the end of the projection horizon in 2022, the new ECB forecasts predict GDP about 3½% below the level expected in the December 2019 projections (i.e. the counterfactual in the absence of the pandemic). This leaves ample spare capacity, which requires further monetary stimulus to push inflation up towards its pre-COVID path. The slight upward revision to core inflation (now seen at 1.1% in 2022, from the previous forecast of 0.9%) still leaves underlying price pressure far below what's needed for the ECB to sustainably lift inflation towards 2%. Second, as fiscal policy is set to remain firmly expansionary for a long time, the ECB will have to remain in the market with sizeable purchases to "anchor" yield curves at around current levels while the fiscal boost makes its way through the economy – effectively, yield-curve control in all but name. Third, the Fed's recent policy shift raises the likelihood of further USD weakness down the road, which would endanger the already shallow upward trajectory in eurozone inflation expected by the ECB.
- The Governing Council did not discuss new stimulus measures yesterday, but Philip Lane's blog published today seems to support the view that monetary policy will be loosened further. Mr. Lane notes "it should be abundantly clear that there is no room for complacency. Inflation remains far below the aim and there has been only partial progress in combating the negative impact of the pandemic on projected inflation dynamics." We expect an expansion of the PEPP before the end of the year, probably by another EUR 500bn through the end of 2021. The announcement might come in December, unless a shock forces early action.

Marco Valli, Head of Macro Research, Chief European Economist (UniCredit Bank, Milan)
+39 02 8862-0537
marco.valli@unicredit.eu

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A comprehensive glossary for many of the terms used in the report is available on our website: https://www.unicreditresearch.eu/index.php?id=glossary

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UniCredit Research*

Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

International Economics Research

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head, Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Anca Maria Negrescu
Senior Economist, Romania
+40 21 200-1377
anca.negrescu@unicredit.ro

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

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