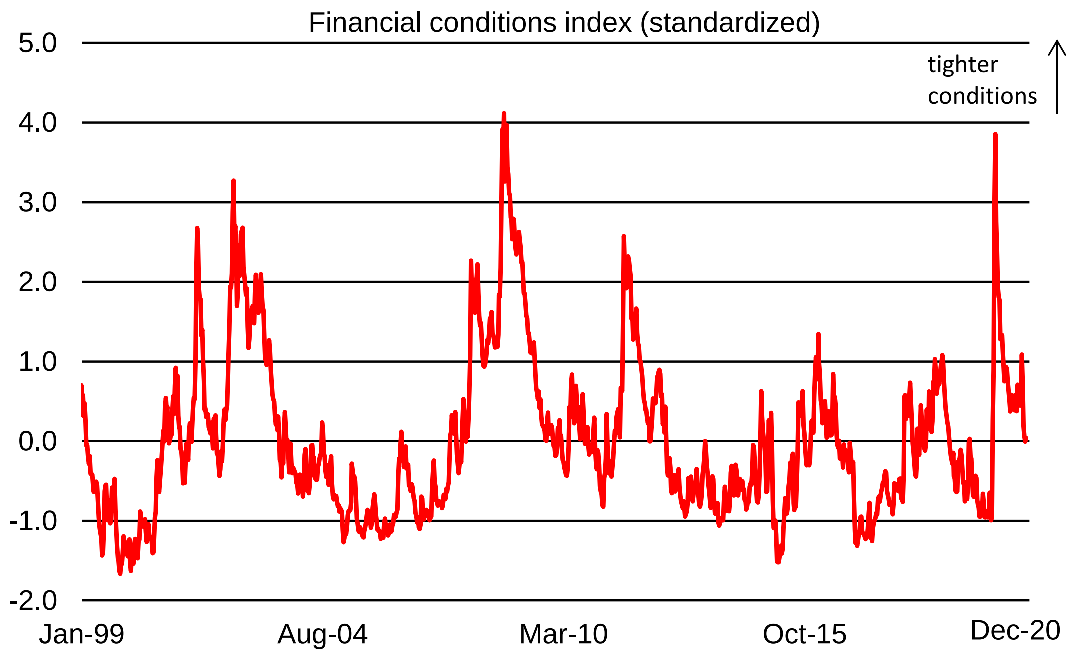
The ECB has done well, but should be more ambitious



Source: UniCredit Research

- The ECB feels good about current financial conditions in the euro area and wants to preserve them throughout next year. Therefore, the new easing measures that were announced yesterday are mainly intended to boost the duration, rather than the intensity, of the central bank's stimulus.
- According to our *Chart of the Week,* the ECB is right, but should probably be more ambitious. The chart shows the UniCredit financial conditions index for the eurozone, which we construct aggregating equity prices, equity implied volatility, corporate spreads, sovereign yields and the trade-weighted euro. When the indicator rises, financial conditions tighten and economic growth tends to slow (and vice versa). Financial conditions have improved dramatically from March when market turmoil induced by COVID-19 reached its peak, and there is no doubt that the ECB deserves great credit for this turnaround. However, financial conditions still remain somewhat tighter than pre-crisis, while the output gap is certainly much larger; this is going to delay even more the recovery of inflation towards the central bank's target. The ECB's new forecasts show headline inflation averaging 1.4% in 2023, with core inflation at only 1.2%. Hence, yesterday the ECB should have probably been bolder.
- We see at least three possible explanations for the ECB's reluctance to go all in. One possibility is that the ECB's preferred indicators of financial conditions depict a more-favorable picture than our own indicator. As already signaled yesterday by Christine Lagarde, financial conditions are a broad concept, they encompass several financial variables and they can be measured in many different ways. A second possible explanation is that the ECB sees limited scope for further improvement in those financial variables that are more directly affected by its intervention. For example, the GDP-weighted sovereign yield curve is already trading clearly below its pre-crisis level. Given that fiscal policy is widely regarded as being more effective than monetary policy in closing the output gap at this stage of the crisis, the ECB might see little merit in acting decisively and prefers, instead, to be a backstop that prevents an upward shift in yields while fiscal stimulus does the heavy lifting. Finally, the ECB might feel that the rollout of vaccines poses stronger upside risks to growth and inflation than publicly communicated. If so, the central bank might want to avoid blockbuster stimulus now in order to minimize the risk of an abrupt exit from crisis measures down the road.

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

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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
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