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The effects of the ECB policy

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Since the cutting of key-lending rates to almost zero in the Eurozone did not suffice to keep the inflation expectations at their long-term target of slightly below 2%, the ECB Council decided in January to expand the central bank money supply until the accomplishment of the target was foreseeable.

The possible effect on the financial market and the economies are multi-faceted. 1) The excessively low inflation expectations increase. This will cause real interest rates (i.e. nominal interest rates minus inflation) to fall. 2) The currency (i.e. the euro) depreciates vis-à-vis other currencies. 3) A so-called asset price effect is created. The ECB buys bonds with low yields, resorting to the central bank money supply. This keeps bond yields very low (partially even negative). Given that, and because the volume of government bonds investable by the private sector shrinks, investors are pushed into asset classes with higher expected yields (bonds with long maturities, bonds with higher default risk, bonds with higher coupons in a foreign currency). This crowding-out effect supports asset prices. The net worth of the holders of these asset classes increases. 4) The willingness of banks to grant loans is supported by the very low bond yields.

Whether the expansion of the money supply really contributes to the achievement of the inflation target is not exactly uncontroversial. That being said, inflation expectations have really increased, real yields have fallen as a result, the euro has depreciated, the spreads demanded for the default risk have narrowed, and share prices in the Eurozone have risen significantly. The effect is amplified by the fact that important economic indicators have improved as well over the past weeks.

In addition, as the example of the Swiss central bank and its abandonment of the exchange rate limit on CHF/EUR shows, a "promise" can also be broken. Basically the question has to be answered how credible it is for the central bank to expand its money supply until the achievement of the inflation targets seems feasible.

Also, the depreciation pressure on the euro forces other central banks to decide on whether to accept the appreciation of their own currency (USA, Switzerland), or whether to put loosening measures in place as well (Denmark, Sweden). The picture of a depreciation race of the currencies is still valid.
Conclusion: the bond purchases by the central bank will have positive effects on the economies and the financial market in the short run. However, the longer the programme takes without engendering any increase of the overly low inflation towards the central bank target, the riskier the situation will become.

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