

## ECB continues with normalisation, keeping maximum optionality

Moving on with tapering and keeping the door wide open for a rate hike before year-end, while ensuring maximum flexibility. Today's ECB announcements were a clear tribute to the past approach of "we never pre-commit"



European Central Bank, Frankfurt, Germany

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The European Central Bank has put a very gradual normalisation of monetary policy in place. A normalisation which is faster than the last announcement at the December meeting but slower than some market participants had expected after the February meeting. Here is what the ECB decided today:

- Confirmation of the end of the Pandemic Emergency Purchase Programme (PEPP) by the end of March.
- Confirmation of an increase in the Asset Purchase Programme (APP) to €40bn per month in April, from €20bn currently.
- A reduction of purchases under the Asset Purchase Programme to €30bn in May and to €20bn in June.
- A de facto end of net asset purchases in the third quarter, at least "if the incoming data

support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases”.

- The downward bias to policy rates was dropped.
- The wording that policy rates could increase “shortly after” the end of net asset purchases was replaced by “some time after”.
- The option to extend the Targeted Long-Term Refinancing Operations (TLTROs) was kept open.

Admittedly, the end of net asset purchases in the third quarter is still somewhat conditional on economic developments and not cast in stone as the ECB also remarked that net asset purchases could still be extended or increased if inflation projections fall below 2%.

## Increasing risk of stagflation but not the ECB's base case, yet

Compared with the latest adjustments to its monetary policy tools in December, this is a slightly more hawkish outcome. Back in December, the rotation from PEPP to APP would have lasted until October. Today's decision has brought forward the €20bn per month purchases by four months. But compared with the comments made at and shortly after the ECB's February meeting, today's decisions are less hawkish than some market participants had expected. The reason for the change of heart is clear: the war in Ukraine has strongly increased the risk of stagflation in the eurozone. Extremely high energy and commodity prices, potential energy supply disruptions, weaker trade, new supply chain disruptions and a high degree of uncertainty for both companies and consumers have changed the eurozone's economic prospects in only a few days.

In the ECB's own economic assessment, such a stagflation risk has already been reflected. With risks to the economic outlook now tilted to the downside and risks to the inflation outlook tilted to the upside, the ECB has joined “team stagflation”, at least for the shorter term. That said, a stagflation scenario is not yet built into the ECB staff projections' base case, with GDP growth expected to come in at 3.7% in 2022, 2.8% in 2023 and 1.6% in 2024. Inflation is expected to come in at 5.1% in 2022, 2.1% in 2023 and 1.9% in 2024. To make these inflation developments less painful, ECB President Christine Lagarde also presented core inflation forecasts, coming in at 2.6%, 1.8% and 1.9% over the next three years. Surprisingly, Lagarde said that the Governing Council “sees it as increasingly likely that inflation will stabilise at its two per cent target over the medium term”.

## Continued normalisation with maximum optionality

All of this means that the ECB is moving on with a very gradual normalisation of monetary policy, keeping maximum flexibility in all directions. This is definitely the best the ECB can do with the ongoing war in Ukraine and extremely high uncertainty. Looking ahead, today's decisions keep the door wide open to a first rate hike before the end of the year. There is very little to nothing the ECB can do to stop the high and possibly even accelerating inflation at the current juncture, and the prospect of stagflation will further complicate the ECB's life and any outright tightening of monetary policy. However, remember that tapering and even returning negative deposit rates back to zero in a central bank's world does not equate to tightening.

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