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ECB preview: Maximum flexibility on the road to normalisation

This week's ECB meeting will not bring the big bang change some had expected a few weeks ago. With the war in Ukraine and its economic implications for the eurozone, the ECB will want to maintain maximum flexibility for its road to normalisation

ECB President Christine Lagarde

The war in Ukraine has made the economic outlook for the eurozone extremely uncertain. No one would want to make any assumptions on how the war will evolve and end, and no one would currently want to quantify the economic implications for the eurozone. This has more than complicated the ECB's position for this week's meeting. A meeting, which roughly two weeks ago, was considered to deliver the starting signal for the ECB's policy normalisation.

The only thing that currently seems clear is that the economic implications of the war in Ukraine have pushed up energy prices and inflation in the eurozone will increase in the coming months instead of gradually declining. At the same time, high uncertainty, potential energy supply disruptions and new supply chain frictions will weigh on the eurozone economy; potentially more than the end of Omicron and improvements in supply chains in Asia could lift growth prospects. In fact, the eurozone is facing a high risk of stagflation.

The minutes of the ECB's February meeting as well as speeches and comments by ECB officials after the meeting suggest that the ECB had been on its way to announcing the first steps of a policy normalisation at the March meeting. However, the latest inflation data and the overall economic picture since the start of the war in Ukraine have once again complicated the road to normalisation. Given that the cut-off for the ECB's staff projections was several weeks ago, any new inflation forecasts can be thrown into the waste paper bin as they are outdated. Even if the ECB was to present a back-of-the-envelope update of the projections based on updated oil price assumptions and ECB President Christine Lagarde stressing that the Governing Council could have its own forecasts, the new uncertainty, as well as the direct economic implications of the war, are simply too hard to model into numbers. As a consequence, we will probably have a situation at this week's ECB meeting in which the inflation projections for 2023 and 2024 could be at 2%, calling for ECB action. In fact, the risk of stagflation has clearly increased, complicating the ECB's dilemma: how to react to accelerating inflation that cannot be softened by monetary policy. No one can seriously expect the ECB to start normalising monetary policy at such a moment of high uncertainty.

Therefore, we expect the central bank to strike a cautious balance between staying on track for policy normalisation while at the same time keeping maximum flexibility. This strategy would mean the ECB sticks to the already announced rotation of its asset purchase programmes, i.e. ending the Pandemic Emergency Purchase Programme in March and increasing the Asset Purchase Programme from €20bn to €40bn, and instead of announcing targets for 3Q and 4Q, announcing a monthly reduction of the net asset purchases by €5-10bn per month, starting in May. Contrary to the December meeting, the ECB will want to avoid hinting at end dates for QE or start dates for rate hikes. At the current juncture, the ECB needs to repeat the promises of Mario Draghi and Jean-Claude Trichet to "never pre-commit". If everything goes well, net asset purchases can still end in the third quarter and interest rates can be hiked for the first time before the end of the year. But this is not for this week's meeting.

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