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An unwavering ECB remains focused on price stability

On Thursday, the European Central Bank (ECB) held key its interest rates at record lows as expected but delivered a hawkish surprise in announcing a faster wind down of its Asset Purchase Program (APP).

At its monetary policy committee, exactly two weeks after Russia's invasion of Ukraine, the ECB said that it would "take whatever action is needed . . . to pursue price stability and to safeguard financial stability". The ongoing geopolitical crisis very much complicates the ECB's task because on one hand, it threatens to materially impact Europe's economic growth, while on the other, it is stoking already red-hot inflation numbers – firstly because Russia is a key source of energy for Europe and secondly, because it will disrupt supply chains of various hard and soft commodities.

Already the Eurozone's flash inflation print for February came in at an all-time high of 5.8%. While the European economy still has a significant amount of growth momentum as we recover from Covid, if the cost of living crisis continues unchecked, demand could evaporate.

To try and prevent runaway inflation, the ECB said it would reduce asset purchases to €40bn in April, €30bn in May and €20bn in June, with purchases in the third quarter being data-dependent. Previously it set purchases at €40bn euros in the second quarter, €30bn in the third quarter and €20bn in the fourth quarter.

The bank's other bond-buying program, the Pandemic Emergency Purchase Program (PEPP), a €1.85tn envelope launched in response to Covid-19, will stop its net purchases at the end of March as planned.

The benchmark refinancing rate remains at 0%, the marginal lending facility rate sits at 0.25% and the rate on the deposit facility was kept at -0.5%. The bank amended the sentence that '*it expects the key ECB interest rates to remain at their present or lower levels*' by scrapping "or lower", making it clear that the next move on rates will be upwards. It also said any adjustments in interest rates will take place "some time" after asset purchase draw to close, and at a "gradual" pace.

In light of stagflation risk and high uncertainty, this gives the central bank maximum flexibility and keeps all options open for a rate hike before year-end.

On the staff projections, growth expectations were revised down from 4.2% to 3.7% for 2022. In the near term, inflation is now expected to be considerably higher, but is expected to come back to target in the medium-term (i.e. by 2024).

A faster wind-down of the asset purchase program might have come as a shock to some investors that were expecting the ECB to strike a softer tone in light of geopolitical events and weaker growth forecasts. However, inflation is drastically above target and it is important that the ECB keeps a laser focus on price stability. After the ECB statement, European core yield curves bear flattened as a rate hike was once again priced in on the short end of the curve. Peripheral spreads widened with Italy underperforming. The euro, which had fallen ahead of the ECB announcement, rebounded.

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