

The European Central Bank (ECB) retained its focus on inflation and raised interest rates by 50 bps yesterday. This is the sixth consecutive rate hike since July'22

The ECB also stated that there is no change in its monetary policy focus on controlling inflation despite the recent concerns of bank stability. The central bank added that it stands to provide additional support for financial institutions if necessary and that euro area banking sector is resilient, with strong capital and liquidity positions. In terms of exposure of financial institutions to Credit Suisse it is limited and there is no concentration as per the ECB.

No guidance was provided on the path of future interest rates other than rate action going ahead would depend on how the economy and inflation develops. That said additional rate increases seem likely.

## **Monetary policy action and economic assessment**

The ECB has risen rates by a cumulative 350 bps in the last nine months. The sharp hikes are an effort to rein in still elevated inflationary pressures and to ensure its timely return to the 2% medium-term target.

With the latest rate hike, the main refinancing operation rate or the cost at which banks can borrow from the central bank for a week would be 3.5%, the marginal lending facility rate which is the cost of overnight credit to banks would be 3.75% and the deposit facility rate which is the interest banks receive for depositing money with the central bank overnight would be 3%. Such high interest rates were last seen in Nov'2008.

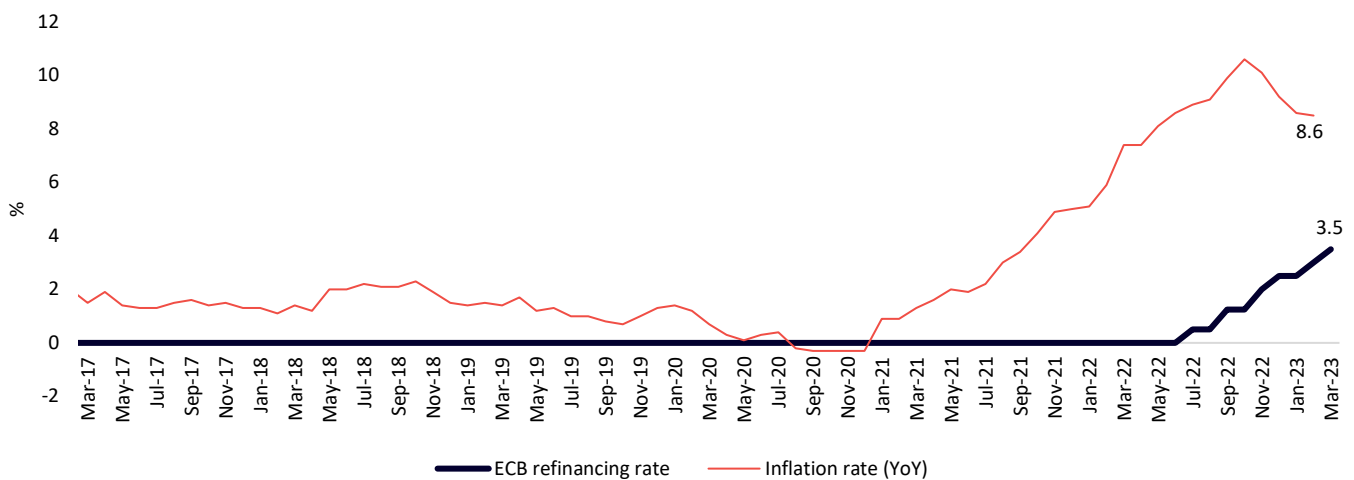
As per the ECB's assessment, the euro area economy is doing better than expected but it remains weak. It is set to recover in the coming months, even though uncertainty has increased. The labour market remains strong with new jobs being created and workers have been receiving higher wages. Also, inflation is still too high and will remain so for some time.

In terms of outlook, given the strong labour market and improving consumer and business confidence, the central bank expects the region's economy to grow by 1% in 2023 and by 1.6% for the next 2 years. However, this outlook is clouded by the recent tensions in the financial markets. In terms of inflation, it is likely to have peaked and is expected to decline gradually. Although the euro regions inflation has been moderating for the last four months owing to decline in energy prices, the core inflation (inflation excluding the volatile items of food and energy) continues to remain high. For 2023 inflation is projected to average 5.3% and 2.9% in 2024. It is expected to be marginally higher than its 2% target in 2025.

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**Exhibit 1: Euro Area Inflation and Refinancing Rate**



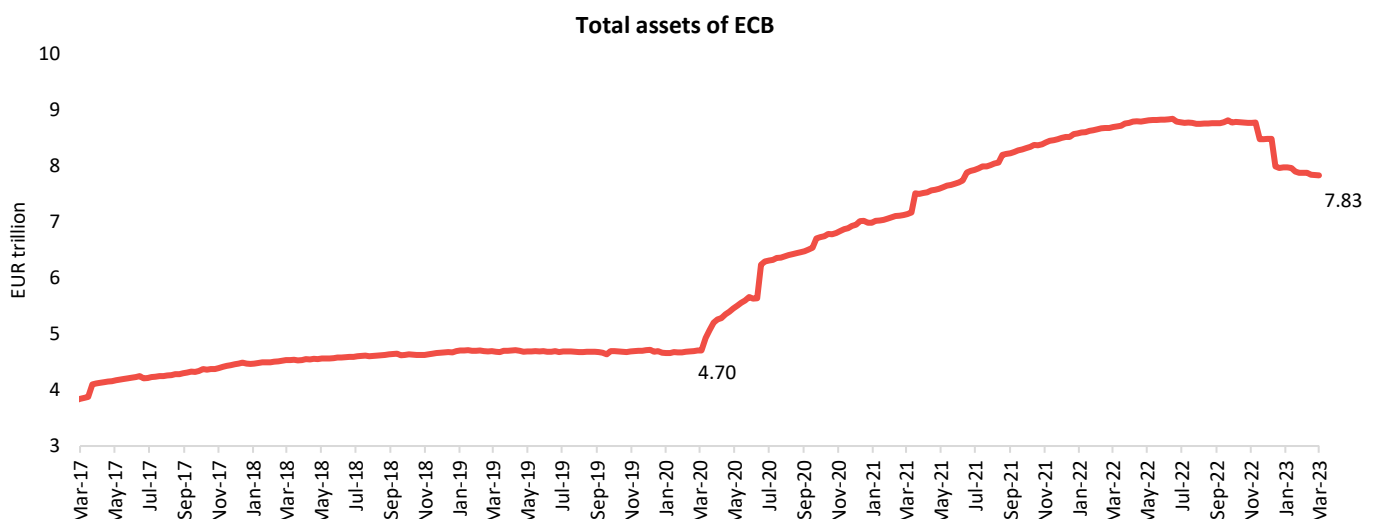
Source: ECB, Nuvama wealth research

## ECB's Quantitative Tightening

The ECB is undertaking quantitative tightening by not reinvesting all of the principal payments from maturing securities from the asset purchase programme portfolio. The ECB in the December'22 policy review had announced that from March'23 it would reduce the portfolio by Euro 15 billion per month on average until the end of June 2023. The subsequent pace of reduction of portfolio would be determined overtime. Under the pandemic emergency purchase programme (PEPP), the ECB intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024.

While some moderation in ECB's balance sheet is seen recently, its total assets continue to remain exceptionally large by historic standards at Euro 7.3 trillion as of 10th March 2023.

**Exhibit 2: The ECB total assets currently stand at Euros 7.3 trillion**



Source: ECB, Nuvama wealth research

## Market Reaction

Following the policy announcement, the short-term bond yields in Europe's largest economies such as Germany and France rose by around 10-20 bps while longer term yields broadly remained stable. On the other hand, Euro strengthened against the USD by 0.3% to 1.061 on the back of Credit Suisse's move to bolster its financial position by borrowing up to USD 54 billion from Swizz National Bank along with ECB's policy tightening decision.

## Going Forward

For the upcoming policy actions, the ECB would remain data-dependent and their policy decision would be based on evolving growth-inflation dynamics and the strength of monetary policy transmission. We expect further policy tightening.

The monetary policy actions of other major central banks are likely to be on similar lines as the ECB given the persistent inflationary pressures. The Fed is likely to raise rates next week (by 25 bps). Recent US economic data does not warrant a change in the Fed's stance on monetary policy.

On the domestic front, with headline inflation surpassing the upper range of the RBI target for the second consecutive month and the unyielding core inflation, there is unlikely to be a let up in the RBI's monetary policy tightening. Price pressures are likely to prevail for the remainder of the fiscal year with headline inflation hovering around 6%. Another rate hike, albeit limited to 25 bps cannot be ruled out at the RBI's next policy meet in early April'23.

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