

ECB slows the pace of policy tightening

The European Central Bank (ECB) retained its focus on inflation and raised interest rates by 25 bps yesterday. This is the seventh consecutive rate hike since July'22, however the pace of interest rate hike has been slowed down from the series of 75 and 50 bps hike undertaken in the previous meetings.

The ECB has risen rates by a cumulative 375 bps in the last ten months. While the inflation has declined over the recent months, the continued policy tightening is an effort to rein in underlying price pressures which continue to remain strong 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 3.75%, the marginal lending facility rate which is the cost of overnight credit to banks would be 4.0% and the deposit facility rate which is the interest banks receive for depositing money with the central bank overnight would be 3.5%. Such high interest rates were last seen in Nov'2008.

In the policy statement, no explicit guidance was provided on the path of future interest rates other than the rate action remains data dependent going forward. However, in the post policy press conference President Lagarde stated that it has more ground to cover to achieve a timely return of inflation to its 2% medium-term target, and that they would not be pausing the rate hikes. This likely suggests that one more rate hike could be on the cards.

In addition, ECB stated that it will keep reducing the Asset Purchase Programme (APP) portfolio at a measured and predictable pace and would likely stop reinvestments under the APP in July'23.

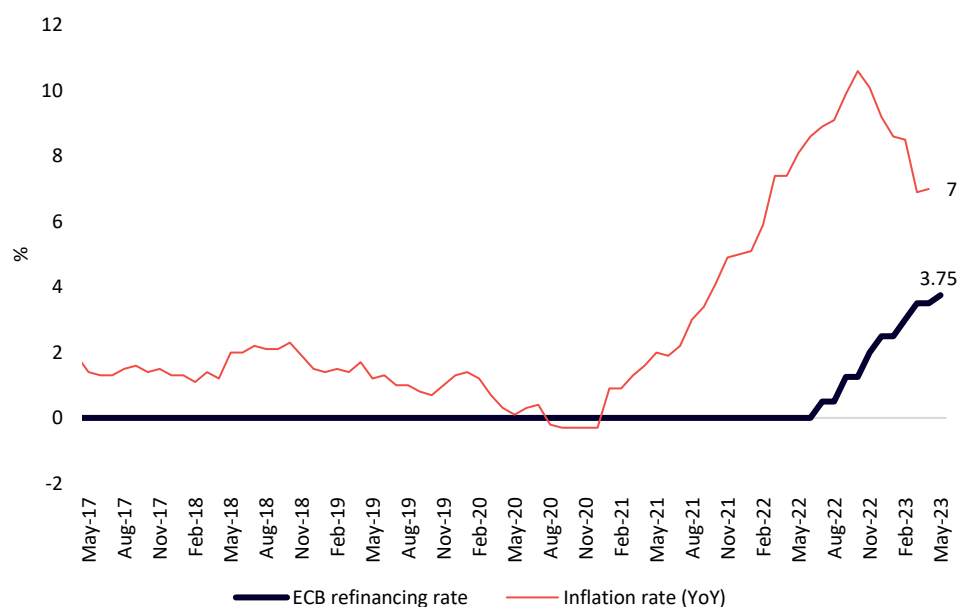
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Exhibit 1: Euro Area Inflation and Refinancing Rate



Source: Nuvama Wealth Research

Assessment of Economy, Inflation, Financial and monetary conditions

Economic Activity

As per ECB's assessment, the euro area economy is doing better with lower energy prices, easing of supply bottlenecks and strong services sector having contributed to the resilience of the economy. Nevertheless, private domestic demand, especially consumption, has remained on a weaker turf.

In terms of growth outlook, given the strong labour market and improving consumer and business confidence, the central bank expects growth conditions to remain stable. However, this outlook is clouded by the recent tensions in the financial markets that could tighten broader credit conditions and dampen confidence. Additionally, the persistent geopolitical conflict between Russia and Ukraine also continues to be a significant downside risk to the economy. Overall, the ECB expects real GDP to grow by 1.0% in 2023, before rebounding to 1.6% in 2024.

Inflation

Overall headline inflation in the Eurozone is likely to have peaked and is expected to decline gradually. Although the euro regions inflation has been moderating owing to decline in energy prices, the core inflation (inflation excluding the volatile items of food and energy) continues to remain elevated. Underlying price pressure have remained strong on account of gradual pass through of past energy price rise, higher services inflation amidst continued unwinding of pent-up demand and rising wages which have led to recouping of the purchasing power.

Looking ahead, the central bank expects upside risk to inflation to emanate from rising inflation expectations, and higher than anticipated increase in wages or profit margins. However, the ECB expects renewed financial market tensions along with weaker demand on account of stronger transmission of monetary policy, to lower price pressures over the medium term. For 2023 inflation is projected to average 5.3% and 2.9% in 2024.

Financial and monetary conditions

With respect to the recent financial market tensions, the ECB stated that conditions in the Euro banking sector have been improving and has proven to be resilient. Overall, the loan growth has weakened owing to higher borrowing rates, tighter credit supply conditions and lower demand. Latest bank lending survey also reported a tightening of overall credit standards and suggested that lending may weaken further owing to a faster transmission of cumulative policy rate hikes.

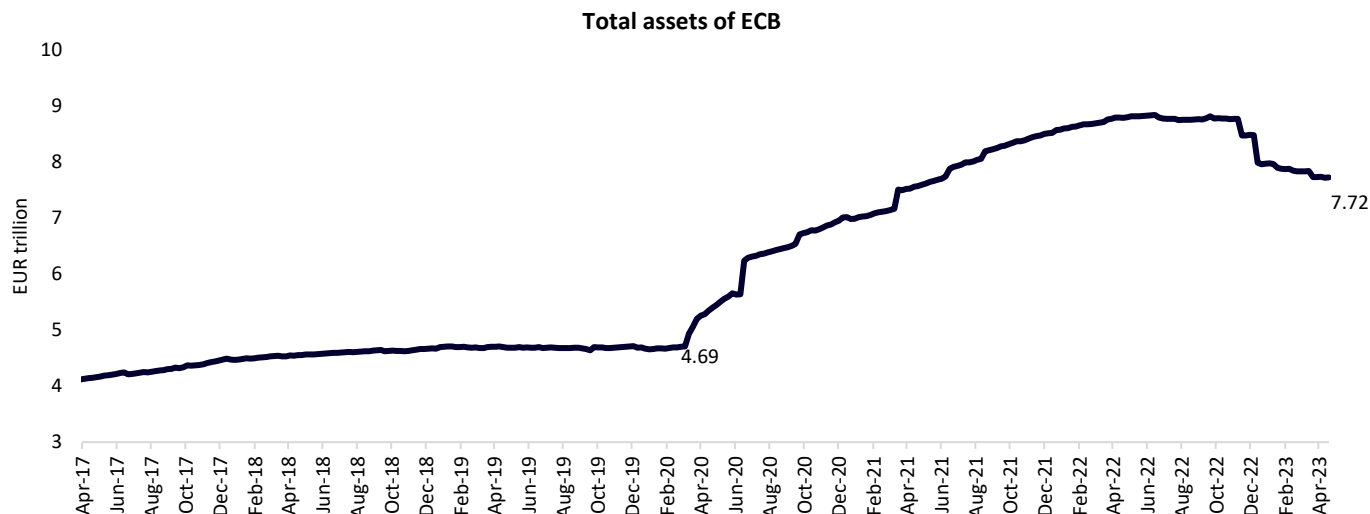
ECB's Quantitative Tightening

The ECB is undertaking quantitative tightening by not reinvesting all of the principal payments from maturing securities from the asset purchase programme portfolio. As a result, the APP portfolio is declining at a measured and predictable pace. The decline will amount to Euro 15 billion per month on average until the end of June'23. In addition to this the ECB further announced that it would likely stop reinvestments under the APP in July'23.

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 7.7 trillion as of April'23.

Exhibit 2: The ECB total assets currently stand at Euros 7.7 trillion



Source: Nuvama Wealth Research

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. The ECB is expected to bring the policy rates to levels sufficiently restrictive to achieve a timely return of inflation to its 2% target and is expected to keep at those levels for a longer period. As such, further rate increases cannot be ruled out just yet given the unprecedented uncertainties associated with the economy, prices, and financial markets.

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