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ECB's monetary policy focussed on supporting inflation

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Set on attaining its elusive inflation target for the euro area on a sustained basis, the European Central Bank (ECB) at its monetary policy held yesterday announced that it would persist with its accommodative monetary policy stance and provide ample monetary accommodation. Towards this end, the ECB maintained status quo on interest rates and agreed to continue with its asset purchases and liquidity operations.

Monetary policy announcements

- Interest rates retained at -0.5% for deposit facility, 0% for main refinancing operations and 0.25% for marginal lending facility. These rates have been in effect since September 2019.
- Interest rates are expected to remain at present or lower levels until inflation attains the 2% target on a durable basis.
- Asset purchases by the central bank under the pandemic emergency programme to be at a higher pace and the buying under the existing programmes to be continued.
- Ample liquidity would continue to be provided to banks via longer term refinancing operations to support credit growth.

Assessment of the euro area economy

- Recovery in the euro area economy is underway with greater number of people getting vaccinated and lockdown restrictions being eased in most countries of the currency block. Consumer spending has been rising and manufacturing sector is expected to perform strongly. Investments are being supported by growing optimism of recovery in domestic and global demand.
- Economic activity is expected to return to its pre-crisis level in the first quarter of next year. At the same time, uncertainty over the pandemic and economic revival prevails on account of the delta variant of the virus
- The rise in inflation is expected to be mostly temporary and outlook for inflation over the medium terms remains subdued. Current increase in inflation is largely being driven by higher energy prices, base effects, and temporary cost pressures in the supply chain.
- Favourable financing conditions required across sectors to sustaining growth and to offset the negative impact of the pandemic on inflation.

Why is inflation the focus of the policy?

Earlier this month (8 July), the ECB as a part of its monetary policy strategy review, revised its inflation target for the euro area from "below but close to 2%" to "2% with temporary deviations above or below the target" over the medium term. Further, for maintaining the target inflation, appropriate monetary policy measures such as asset purchases, long term refinancing operation and forward guidance would be used.

Inflation of 2% is sought to avoid being constrained in a low inflation (risk of deflation) and low interest rate scenario. Inflation is the euro area has been below 2% on a near sustained basis since 2013, despite low interest rates.

Although there has been an increase in inflation in recent months (year- on- year growth of 2% in May'21 and 1.9% in June'21), it is viewed as being temporary and expected to decline next year. The ECBs outlook for inflation for the medium term continues to be below the target at 1.3% for 2022, 1.4% in 2023 and 1.7% in 2026. A hike in interest rates till 2026 can thus be ruled out.

Asset purchases for attaining inflation target

Bond buying has been among the main monetary policy tool of central banks, ECB included, in response to the pandemic emergency. In case of the ECB, the asset purchases that were in existence before the pandemic were aimed at stimulating growth and thereby inflation.

The ECB launched the pandemic bond buying programme (PEPP) in March 2020. Under this programme which is temporary in nature, public and private sector securities are bought. The limit of these bond purchases was raised from the initial € 750 billion to € 1.85 trillion and is proposed to last at least till March 2022.

The ECB has as a part of the PEPP, purchased (net) bonds amounting to €1.18 trillion during March 2020 to June 2021. This is 64% of the proposed purchases under the programme. In the three months to June 2021, the monthly purchases were around € 80 billion, notably higher than the average € 56 billion of January-February. The pace of asset purchases by the ECB is expected to increase in the coming months. The ECB has indicated that the bond buying would be flexible according to market conditions and would be done in a manner to prevent the tightening of financing conditions.

The PEPP is in addition to the ongoing (since Oct 2014) Asset Purchase Programme (APP) of € 20 bn per month. The holdings under the APP as of June 2021 is € 3.02 trillion.

Market reaction to the policy

European equities rose, bond yields declined, and the Euro weakened as the ECB committed to maintain its loose monetary policy for the foreseeable future.

The benchmark German Stock Index (DAX) closed 104 points/ 0.67% higher yesterday. Similarly, stock indices for France (by 0.45%), Italy (1.40%), Spain (0.71%), Netherland (0.79%), Sweden (0.77%), Greece (0.46%) and Portugal (0.57%) were amongst those from the euro area that rose yesterday.

The yields on the benchmark 10-year sovereign bonds declined yesterday for the major economies of the euro area such as Germany (3 bps), Italy (5 bps), France (4 bps), Greece (1 bp) and Portugal (2 bps).

The Euro weakened against the USD by 0.17% from 1.1792 to 1.7772.

Policy action of other central banks

Even as the key central banks viz., the US Federal Reserves, Bank of England, Bank of Japan and European Central Bank, have been maintaining their pandemic related monetary stimulus viz., bond (public and private) purchases and ultra-low interest rates, some other central banks have started winding down the pandemic related monetary support with the uptick in inflation.

Brazil, Russia, Hungary, Mexico, Venezuela, Chile, Czech republic, Iceland and Singapore are amongst those that have tightened their monetary policy and raised interest rates in recent months.

The central banks of Canada, Australia and New Zealand have reduced/ announced the tempering of (pandemic period) bond purchases

Implications for India

The ECB policy would not have a direct bearing on the monetary policy decision of RBI. Contrary to the ECB that is faced with persistent low inflation, the RBI has had to reckon with high inflation that has surpassed its target for extended periods. With the RBI's focus on facilitating economic recovery, it is unlikely to shift its accommodative monetary policy despite the build-up in inflation here.

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