INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Governing Council meeting, ECB. 15/12/2022

All lending rates increased by a further 0.5%

The ECB's Governing Council held its final meeting of the year on 16th December and, as widely expected, voted further to hike the cost of borrowing. Like the US Federal Reserve and the Bank of England, the members voted for a smaller rate increase – 0.5% as opposed to the 0.75% rate rise announced on 27th October. Since June, the cost of borrowing has risen by 2.5% in total. In the press conference following the meeting, Christine Lagarde, the ECB's President not only hinted of further rate rises in 2023 due to the continuing high level of inflation but also announced a plan to shrink the ECB's balance sheet. Maturing assets purchased under the 2019 Asset Purchase Scheme will be run off at a rate of €15b. per months from March until June 2023 at which point the rate of run-off will be reviewed. There are no plans to run off any assets purchased under the much larger 2020 Pandemic Emergency Purchase Programme until at least the end of 2024.

The ECB was one of the last major central banks to tighten monetary policy, out of concerns that the increase in bond yields which normally accompanies higher lending rates could be problematical. The Governing Council does not want a repeat of the sovereign debt crisis of the early 2010s where a widening spread between the yield on 10-year German Bunds and 10-year Greek government debt threatened the very future of the single currency. Italy is now the most at-risk member of the Eurozone and yesterday's announcement saw yields on its 10-year bonds rise to 4.3% but the ECB presumably feels that ongoing high inflation is a greater concern. Consumer prices rose by 10.1% across the 19-nation bloc in the year to November, a modest decline on October's reading of 10.6%, which possibly may be the peak reading in this particular inflationary cycle. With producer prices still rising at over 30%, it is quite clear that inflationary pressures are likely to persist for some time. Indeed, in some member states, notably Lithuania and Estonia, the current annual inflation rate remains above 20%.

The quantity of broad money (M3) fell by €67b. during October, the first monthly contraction since 2019. Since the asset purchase programmes were wound up earlier this year, new bank credit to the private sector has been the main driver of broad money growth. The recent strong growth in new mortgage lending slowed slightly during the month but growth in new credit to businesses remains robust. Indeed, October's reading of 8.1% is the highest in some years. Higher borrowing costs may perhaps deter some businesses or households from taking on additional debt in the coming months and this, along with the ECB's plans to reduce its stock of assets could accelerate any contraction in broad money. Although it could point to November's fall in inflation as a vindication of its decision to tighten monetary policy in recent months, this not the real reason why price pressures are easing slightly. It is rather that the worst effects of the huge increase in broad money in the second quarter of 2020 have worked their way through the system. Inflation is likely to remain well above the ECB's 2% target throughout 2023 as broad money growth remained well above the optimum 4%- 5% band for developing countries. By ignoring the slowdown in broad money and tightening monetary policy too drastically, the ECB runs the risk of creating a recession in late 2023 or 2024.

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