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## The ECB and the War



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### The tragedy in Ukraine must not stand in the way of normalisation

Economists around the globe are currently trying to grasp the economic consequences of the war. But there are simply too many unprecedented events coming together right, rendering it impossible to base any predictions based on historical patterns: a lingering pandemic, dislocated supply chains, and now a massive war on our doorstep. Uncertainties have reached extreme levels.

#### Inflation will get even more of a boost

One of the few certainties, however, is likely to be a further rise in the rate of price increases. Already in February, inflation in the euro zone soared to 5.8%, an all-time high!

The rapid rise in the prices of gas, oil and grain, as well as many other commodities, since the beginning of the war will further fuel inflation. The ECB is not blind to this fact. Its forecasts presented yesterday raise inflation rates for this year and for the coming years. In any case, the inflation target of 2% will be clearly exceeded in the current year, and inflation is also likely to be higher in the coming year. Given the current uncertainty, the ECB projection for 2024 (1.9%) is more of a statement than a forecast.

The ECB has reacted and yesterday set the course for an interest rate hike. Bond purchases are set to end in the third quarter. Towards the end of 2022 the interest rate screw will then be tightened ever so slightly; always assuming the Ukraine war does not bring unexpectedly large slumps in growth.

#### Second-round effects do not ask about causes of inflation!

The ECB was right to stick to normalization. Because with prices rising steadily, inflation expectations will become more entrenched. Companies and trade unions react to rising prices.

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The inflation rate keeps rising at an accelerating pace. The ECB takes note

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Solidarity with Kiev is unlikely to be expressed in wage restraint and margin sacrifice. At the same time, the price increases are no longer due solely to higher energy costs. In January, prices of more than three-quarters of all categories in the basket rose faster than the 2% inflation target: a rapid increase over time (see chart).

Historically, macroeconomic scars caused by geopolitical crises have often been of a short-term nature. In the case of the Ukraine war, government demand is likely to increase, not only to drive investment in national defense and energy security, but also to cope with the expected massive flow of refugees. This will also raise inflation, as spare capacity in the euro area is low: in January, unemployment reached its historically lowest level.

### Recession risks increase if the ECB acts too late

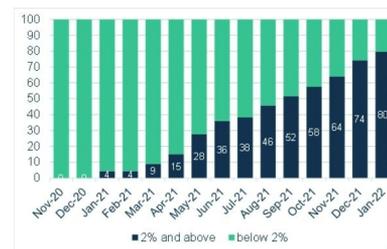
President Lagarde acknowledged that the ECB's decision was not unanimous. After all, there were already voices from the Council in the run-up to the decision that it was too early for normalization.

However, a central bank that acts too late but then strongly is all too often the reason for economic slumps. It has been over 70 years since the U.S. reduced inflation from over 5% to a moderate level without causing a recession.

The ECB must draw the right conclusions from this. Monetary policy normalization must not be put on the back burner. The inflationary impact of war makes this even more urgent. Yesterday the ECB reaffirmed at least that it plans to move in the right direction, even if it lurches forward only at a glacial pace.

### Share of categories in the HICP consumer basket whose prices rose faster than 2%

(Euro Area, 3-month MAV)



Source: LBBW Research, ECB

## Monetary policy errors are the most common causes of recessions.

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