

# European Central Bank moves to tighten monetary policy

Nick Beams  
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The European Central Bank (ECB) has surprised financial markets with the decision by its governing council on Thursday to begin tightening monetary policy even as Europe is faced with possible financial turmoil and a slide into recession because of the conflict with Russia.

The general view in financial circles was that the ECB would put its moves towards so-called “normalisation” on hold. Instead, it set out a plan to reduce its purchases of government bonds more quickly. Under the previous plan, monthly asset purchases would be reduced from €40 billion to €20 billion in October. Now they will be cut to €20 billion in June.

According to the *Financial Times*, the decision has been taken as a signal that the ECB will start raising interest rates in the fourth quarter in a bid to clamp down on inflation—the first such move in more than a decade.

The decision is a significant concession to northern European members of the ECB, led by Germany, which have been pushing for action by the central bank on monetary policy in the face of higher inflation.

The inflation rate for the euro zone rose from 5.1 percent in January to 5.8 percent in February and could go much higher because of the surge in energy prices.

In her introductory remarks to a press conference, ECB president Christine Lagarde said the bank expected inflation to rise further in the near term.

“Energy prices, which surged by 31.7 percent in February, continue to be the main reason for this high rate of inflation and are also pushing up prices across many other sectors. Food prices have also increased, owing to seasonal factors, elevated transportation costs and the higher prices of fertilizers. Energy costs have risen further in recent weeks and there will be further

pressure on some food and commodity prices owing to the war in Ukraine,” she said.

In the question-and-answer session, Lagarde took issue with a journalist who asked how much agreement there was in the governing council about “accelerating the pace of normalisation.”

Lagarde attempted to maintain the façade that the ECB has the situation under control when economic and financial conditions are changing daily. She said “accelerated normalisation” was not “the decision that was made today.” Rather it was necessary “to progress step by step,” while acknowledging the uncertainty, “so that we can in all circumstances respond in an agile way.”

Lagarde’s claim that the ECB was not “accelerating” got short shrift in financial circles. “Sorry but, yes, you are,” was the response from one economist at a wealth management firm in Geneva cited by the *Wall Street Journal*.

A former vice-president of the ECB, Vitor Constâncio, tweeted that “the changes were unnecessary in my view, and all tilted to tightening policy.”

In taking its latest decision, the ECB was confronted with a conundrum that will also face the US Federal Reserve when it meets next week.

On the one hand, the central banks want to clamp down on inflation, lest there is a repeat of the experience of the 1970s when it produced a major upsurge in the struggles of the working class. On the other, they are fearful that tightening monetary policy could result in turmoil in the financial markets, so dependent have they become on virtually free money, and set off a recession.

For three decades and more, central banks have not had to contend with inflation because of cheaper goods

resulting from globalization and the suppression of the working class by the trade unions. But inflation is now taking off world-wide. The 7.9 percent increase for the US in February is indicative of global trends, with inflation in poorer countries likely to be much higher.

Three interconnected factors have been at work. First, the refusal of governments around the world to enact meaningful public health measures to deal with the COVID pandemic, lest they disrupt the stock market, has led to the inflationary supply chain crisis.

Second, the pumping of ever more money into the financial system has fuelled speculation not only in stocks and financial assets but also commodities.

Third is the economic war aimed at the destruction of the Russian economy, in the hope economic and social devastation can create the conditions for “regime change” and the eventual dismemberment of the Russian Federation. Russia is the world’s 12th largest economy and a major global supplier of energy and gas, industrial metals, and food, particularly wheat.

In her prepared statement, when dealing with financial conditions, Lagarde was anxious to offer reassurances of calm and stability.

Expressing the delusionary thinking in ruling circles, she said: “The financial sanctions against Russia, including the exclusion of some Russian banks from SWIFT [the international financial messaging system], have so far not produced severe strains in money markets or liquidity shortage in the euro area banking system.”

In answer to a question at the press conference on financial stability, ECB vice-president Luis de Guindos said that “in terms of the exposure of the European financial sector to Russia, it’s not very, very relevant.”

For this writer it recalled the comment by the then Fed chair Ben Bernanke in 2007, who said growing problems in the US sub-prime housing mortgage market would not have a major effect because it was a very small segment of the financial system. In September 2008, the sub-prime crisis led to the biggest financial collapse since the 1930s.

Just two days before ECB officials gave their upbeat assessments of financial stability, the London Metal Exchange (LME) closed its nickel market—for which Russia is a key supplier—after prices had doubled overnight.

The crisis was sparked by the fear that a major

Chinese nickel firm, Tsingham Holding Group, faced a \$1 billion margin call from lenders and would not be able to pay, which would drag down other traders with it.

The company’s CEO had made bets that the nickel price would fall and, according to initial reports in Chinese media, was facing total losses of as much as \$8 billion.

Rather than let it go down, the LME closed the nickel market, halting trades estimated to be worth \$4 billion.

The incident recalled the demise of the \$3 billion hedge fund Long-Term Capital Management (LTCM), run by some of the supposedly brightest minds in the financial world, in September 1998 because of wrong bets it had made on the Russian rouble. LTCM had to be bailed out by the New York Federal Reserve lest its bankruptcy lead to a broader financial crisis.

As firms pull out of Russia and the prospect of a Russian default on its sovereign debt increases, some financial firms are reportedly concerned, not so much about their own exposure to Russia, but to what extent their clients are exposed.

Others may be directly impacted. It has been reported that the giant bond trading firm Pimco could be on the hook for large amounts of money if Russia defaults. It has more than \$1 billion in credit default swaps on its books.

These are a kind of insurance policy taken out by holders of the bonds in case of a Russian default. In effect, Pimco has made a bet that will not happen—an event, however, that is looking increasingly likely, with major flow-on effects.



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