ECB Watch

AIB Treasury Economic Research Unit

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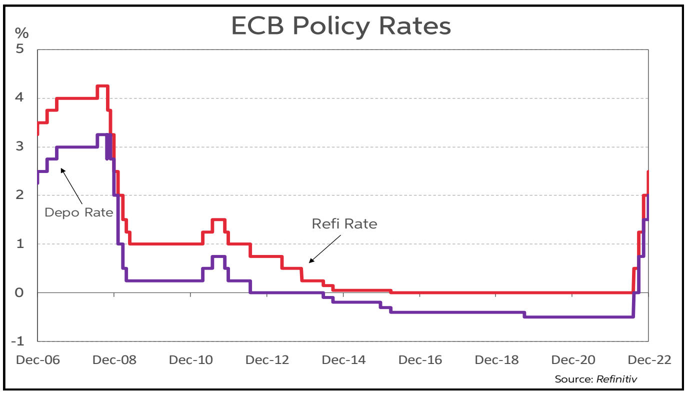
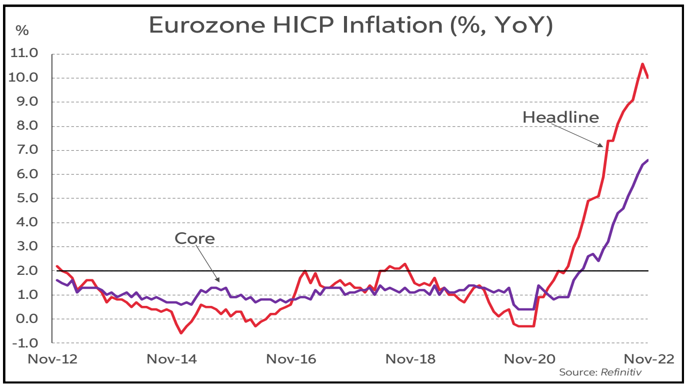
Very hawkish ECB signals a lot more to come on rate hikes

The December meeting of the ECB's Governing Council saw the central bank raise rates by 50bps. This follows two consecutive 75bps hikes in interest rates in the autumn and the initial 50bps move in July. It brings the total amount of tightening in H2 2023 to 250bps, with the deposit rate being raised from –0.5% to 2.0%. The move was in line with markets expectations as talk of a 75bps hike had ebbed recently.



The ECB is not in any way done yet, and the move to a smaller rate hike should not be taken as a sign of an imminent end to its hiking cycle. **Indeed, in a clearly hawkish signal, the Governing Council warned that interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target.** It added that keeping interest rates at restrictive levels will over time reduce inflation by dampening demand, a clear nod not to expect any early reversal of policy.

The ECB repeated that inflation remains far too high and is likely to stay above target for an extended period of time. It also noted that price pressures have broadened across the economy. The headline HICP rate hit 10.6% in October before easing back to 10% in November, reflecting falling energy prices. The core rate that excludes energy and unprocessed food, though, accelerated from 6.4% to 6.6%. **The ECB's latest inflation forecasts contained in its todays updated macro projections show significant upward revisions.** It now sees inflation averaging 6.3% in 2023, up from 5.5% previously, with the 2024 forecast upped significantly from 2.3% to 3.4% and from 1.9% to 2.3% in 2025.



President Lagarde acknowledged, though, that the Eurozone now faces a short, shallow recession. Growth was stronger than expected in the first half of the year, but the economy is now clearly losing momentum. The ECB sees GDP contracting in Q4 2022 and again in Q1 2023. It lowered its 2023 GDP growth forecast to 0.5% from the 0.9% contained in its September macro projections. It still sees the economy recovering appreciably in 2024-25 with the growth predictions virtually unchanged at circa 1.9% in both years.

Futures contracts hardened after the ECB rate decision announcement and press conference. The market now sees rates peaking at circa 3.15% by the middle of next year. President Lagarde, though, stated that the ECB expects to raise rates in 50bps steps for some time to come suggesting that rates could rise to 3.5% or above next year. The markets seem sceptical that the ECB will raise rates to this extent with the economy likely to be in recession. However, the ECB was clear that it will do what is necessary to bring inflation down to 2% over the medium term.

The ECB also set out its plan today for Quantitative Tightening (QT) in 2023. From March 2023, it will no longer reinvest all of the principal payments of its maturing securities in its asset purchase programme (APP) portfolio. The decline will initially amount to €15 billion per month up to mid-2023 and its pace subsequent to that will be determined over time.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2022	2023	2024	2025
HICP	8.4	6.3	3.4	2.3
Real GDP	3.4	0.5	1.9	1.8

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $104.6 in 2022, $86.4in 2023, $79.7 in 2024 and $76.0 in 2025

Source: ECB December 2022

Overall, the ECB struck a distinctly hawkish chord today, clearly signalling that rates will have to rise by far more than markets anticipate to bring inflation back to target. While futures contracts hardened, they are reluctant to price in the scale of tightening envisaged by the ECB. Two year German yields rose by 25bps with ten year yields up by 15bps. There was a much in bigger jump in peripheral yields, most notably in Italy, while the euro posted some modest gains.

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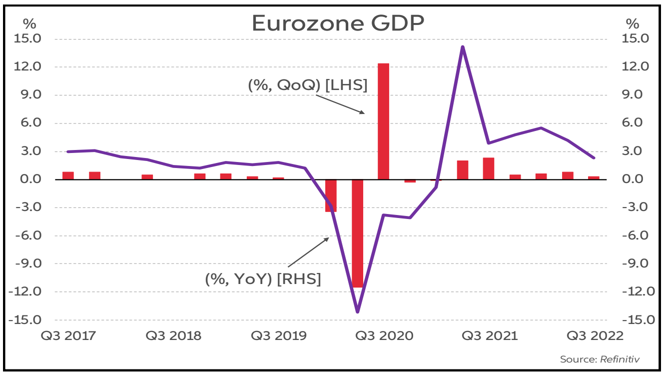
Eurozone economy on the cusp of recession



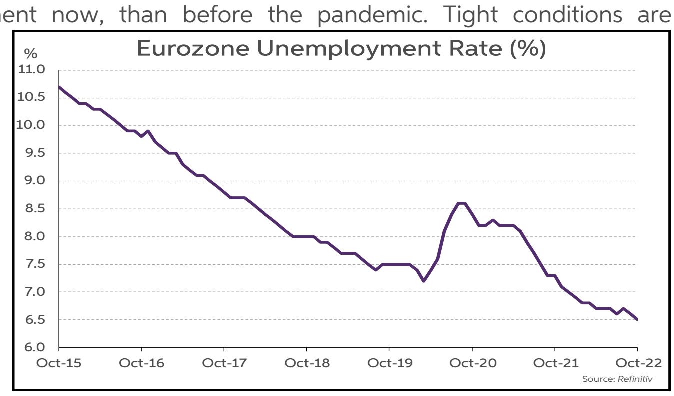
Eurozone GDP expanded by 0.6% and 0.8% in the opening two quarters of 2022. **However, the economy has lost considerable pace in the second half of the year, with GDP growth slowing to 0.3% in the third quarter.** The underlying breakdown for Q3 shows that household consumption remained a significant driver of growth, increasing by 0.9%, and adding 0.5 percentage points (p.p.) to GDP. Increases in fixed investment also contributed positively to GDP, adding 0.8 p.p. to the total. However, this appears to have resulted in much higher imports (+4.3%), which rose by far more than exports (+1.7%) meaning net trade subtracted 1.1 p.p. from GDP. Inventories added 0.2 p.p. to Q3 GDP.

Activity appears to have slowed even further in Q4, with a contraction in GDP generally expected. Retail sales fell by a very sharp 1.8% in October, suggesting the consumer side of the economy is starting to falter in the face of surging inflation and rising interest rates. Non-food sales in stores were particularly weak. Meanwhile, industrial production has been quite volatile this year, largely due to multinational activity in Ireland. Industrial output plunged by 2% in October, having risen by 0.8% in September, with the data once again impacted by large swings in the Irish reading. Notably though, German industrial production has softened markedly in the second half of the year.

Survey data are also consistent with the Eurozone economy losing momentum. The manufacturing PMI, which averaged 54.2 in Q2, printed below the key 50 threshold throughout Q3, averaging just 49.3. It fell further in October and November, averaging 46.8. Similarly, the services PMI averaged 49.9 in Q3, down from 55.6 in Q2, before declining to 48.5 in October/November. These readings point to a contraction in the economy in Q4. Meanwhile, the EC sentiment index, which has been trending lower since the onset of the war in Ukraine continued to weaken in Q3, before falling in October to its lowest level in two years. The index staged a slight rebound in November, but remains at very low levels. Elsewhere, having fallen to its lowest level on record in September, consumer confidence recovered somewhat in October and November.

In terms of inflation, headline HICP hit a peak of 10.6% in October, before easing to 10% in November on a decline in energy prices. However, inflation has become broad based and there is continued upward pressure on food prices. The annual rate of inflation for food, alcohol and tobacco accelerated to 13.6% in November, while the core rate that excludes these three components as well as energy, was unchanged at 5%. The latest ECB forecasts show headline inflation averaging in 6.3% in 2023 and 3.4% in 2024, much higher than its previous projections.

Meanwhile, with the economy having recovered strongly from the pandemic, labour market conditions have tightened considerably. The Eurozone unemployment rate which has been trending downwards since the start of 2021, fell to a new record low of 6.5% in October. Employment moved above its pre-pandemic level in Q4 2021, and has continued to rise this year. It was up by 0.3% in Q3 for a year-on-year gain of 1.6%. Overall, it is estimated there are three million more people in employment now, than before the pandemic. Tight conditions are contributing to increased labour costs. The latest official data which is for Q2, shows that wages rose by 4.1% on an annual basis in the quarter, although the data remain somewhat distorted by base effects. A more timely measure of wage growth inflation for some of the large Eurozone economies, based on job postings data, indicate that wages have risen by 5.2% y/y in October.



The Eurozone economy is facing a very challenging period. Surveys of industry and consumers point to a contraction in GDP. The war in Ukraine will continue to weigh on economic activity both directly and indirectly, in particular by reducing real incomes through higher inflation. Monetary policy and financial conditions have tightened considerably. GDP could well contract in this quarter and the early part of 2023. Looking ahead, the Eurozone may face a significant challenge re-filling its gas storage facilities without Russian imports before next winter. Both the OECD and IMF are forecasting the euro area economy will grow by 0.5% in 2023. Similarly, the latest ECB staff projections are for growth of 0.5% next year.

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