ECB Watch

AIB Treasury Economic Research Unit

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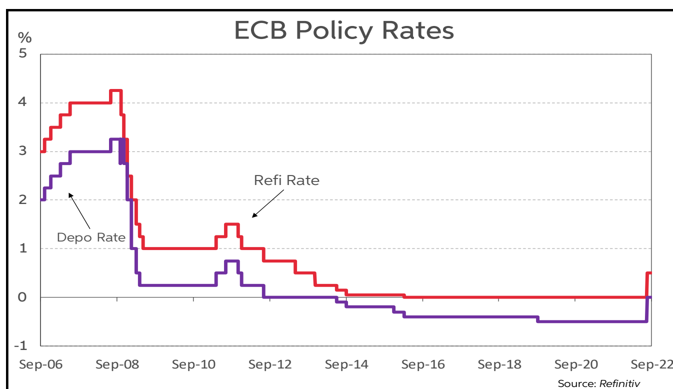
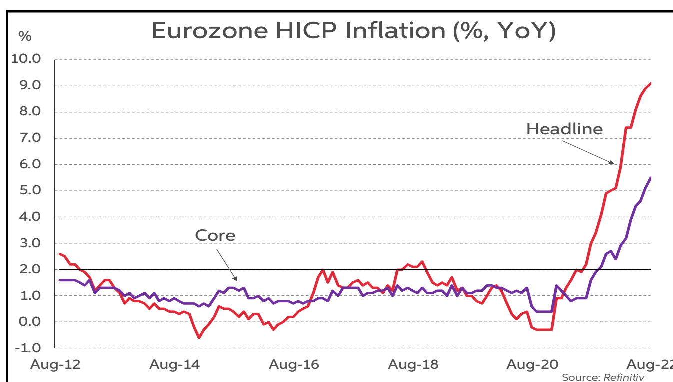
ECB frontloads rate hikes and promises more tightening to follow

The ECB's Governing Council meeting for September saw the central bank implement its largest ever rate hike, announcing a 75bps increase in interest rates. This follows a 50bps increase at its last meeting in July, when it ended its negative interest rate policy. The deposit rate will rise to 0.75% (from 0.0%), while the refi rate will increase to 1.25% (from 0.50%). The decision was unanimous, although it followed a debate within the Council that had "differing views" and a "thorough discussion". Over the last number of weeks, the market had moved towards pricing in a 75bps hike against the backdrop of increased hawkishness from a number of ECB members. **The meeting statement outlined the ECB's rationale for the frontloading of rate hikes.** It commented that inflation remains far too high and is likely to stay above target for an extended period. It also noted that price pressures have broadened across the economy and inflation may rise further in the near term. Therefore, it assessed that it needed to front load its rate hikes to ensure a timely return to its 2% inflation target over the medium term.



The ECB's inflation concerns are evident in their updated macro projections. It revised higher its 2022 inflation forecast to 8.1% (from 6.8%). For 2023 it expects inflation to average 5.5% (was 3.5%). It also upped its 2024 projection to 2.3% (from 2.1%). Meantime, while its 2022 GDP forecast was upgraded to 3.1% (from 2.8%) to take account of the better than expected performance in H1'22, it downgraded its growth forecasts for the period 2023-24. It stated that it anticipates the economy will stagnate later this year and into Q1'23, with the hit to consumers purchasing power from very high energy prices, supply bottlenecks, and the impact on consumer/business confidence from geopolitical risks, combining to dampen economic activity. It revised lower its 2023 and 2024 GDP growth forecasts to 0.9% (from 2.1) and 1.9% (from 2.1%), respectively. In its updated downside scenario, which includes a full shutdown of all Russian gas supply to the Eurozone and energy rationing, it projects GDP to average 2.8% this year, -0.9% next year, and 1.9% in 2024.



The ECB guided that it expects over the next several meetings to raise interest rates further to "dampen demand and guard against the risk of a persistent upward shift in inflation expectations". In the press conference, President Lagarde stated that "several" is "probably more than two including this one but it is probably also going to be less than five". It also continued to emphasise that its future policy decisions will be data dependent and follow a meeting-by-meeting approach. However, the President provided no indication as to where the ECB sees the 'terminal rate'. She stated that the ECB is still far away from the rate it hopes will help bring inflation back to its 2% target. Overall, taking on board the meeting statement and President Lagarde's comments, the ECB is clearly stating that its key objective is to bring inflation back down to its target and not the rising recessionary risk facing the economy.

There are two ECB meetings remaining this year (Oct 27th and Dec 15th). Futures contracts suggest that the market is expecting a 50bps of a rate hike in October and another 50bps in December. This would see the Depo rate ending 2022 at 1.75%. Further out, the market is anticipating in the region of 50bps of tightening in 2023. If this materialised it would result in the depo rate peaking at 2.25% by mid'23 and stabilising in and around this level into the end of next year. In terms of market reaction to today's meeting, EUR/USD edged lower due to some dollar strength rather than euro weakness. Meanwhile, there was a broad-based move higher in Eurozone yields, with the policy sensitive 2-year German yield up around 23bps to above 1.3%.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2021	2022	2023	2024
HICP	2.6	8.1	5.5	2.3
Real GDP	5.4	3.1	0.9	1.9

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $105.4 in 2022, $89.8 in 2023 and $83.6 in 2024.

Source: ECB September 2022

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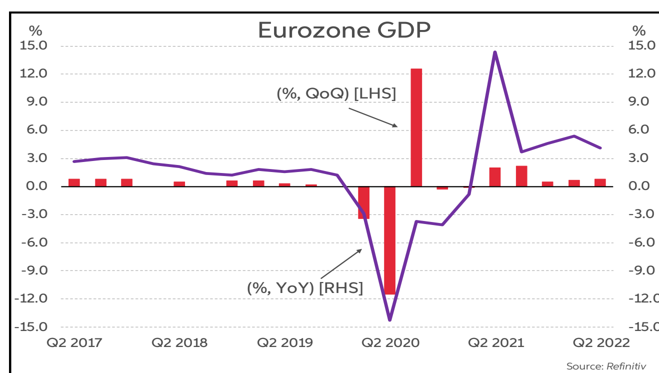
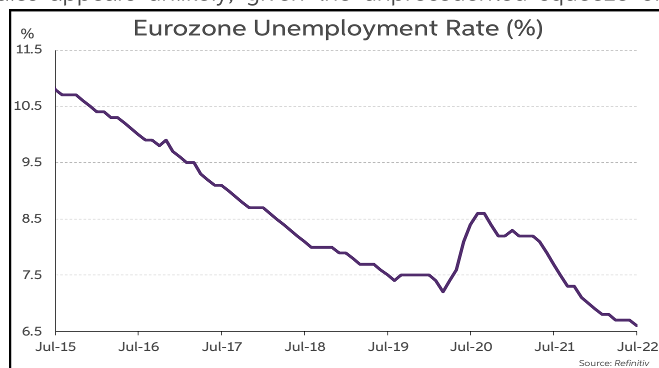
Risk of a recession increases as inflation surges

Having expanded by 0.7% q/q in the opening three months of the year, Eurozone GDP accelerated slightly in the second quarter, increasing by 0.8%. The underlying breakdown shows that household consumption increased by 1.3%, adding 0.6 percentage points (p.p.) to growth. Increases in government expenditure and investment also contributed positively to GDP, adding 0.1 p.p. and 0.2 p.p., respectively, to the total. Meanwhile, imports (+1.8%) rose by more than exports (+1.3%) meaning net trade subtracted 0.2 p.p. from GDP. The contribution from changes in inventories was negligible in the quarter. Overall, the Eurozone economy performed above expectations in the first half of the year.



However, survey data suggests the Eurozone economy has lost some momentum in the third quarter. The manufacturing and services PMI averaged 54.1 and 55.6 in the second quarter. However, both declined in July and August, moving into contraction territory. The manufacturing PMI printed at 49.8 in July and 49.6 in August, with demand for new orders deteriorating sharply. The August reading was the lowest for the sector since June 2020. Meanwhile, the services index was at 49.8 in August, as elevated levels of inflation and concerns regarding the economic outlook weighed on firms activity. The EC economic sentiment index, which has been trending lower since the onset of the war in Ukraine has continued to do so in Q3, falling to its lowest level since February 2021, in August. Elsewhere, consumer confidence plunged to its lowest level on record in July, and remains close to this reading in August, as surging inflation weighed on real household incomes.

Retail sales for July are currently the only available Eurozone wide hard data on activity for Q3. Headline sales rose by 0.3% in the month. However, increased food and fuel spending masked a decline in sales of all other items. Sales excluding food and fuel fell by 0.4% in July. Overall, retails sales were about 2.5% below their peak level from November last year. A sustained upturn in retail sales appears unlikely, given the unprecedented squeeze on household incomes due to very elevated inflation.



In terms of inflation, headline HICP rose to 9.1% in August, from 8.9% in July. Although energy inflation fell for the second month running, it remained the main contributor to the headline rate, and was up 38.3% year-on-year. Worryingly, inflation has continued to become more broad based, with the ex-food & energy rate jumping to 5.5%, from 5.1% in July. The conflict in Ukraine has placed continued upward pressure on a large swathe of commodity prices, most notably, natural gas, wheat and oil. The latest ECB inflation forecasts show inflation averaging 8.1% in 2022 and 5.5% in 2023.

Meanwhile, having recovered strongly, labour market conditions appear to be quite tight. The unemployment rate which has been trending downwards since the start of 2021, fell to a new record low of 6.6% in July, from a "Covid peak" of 8.7% in mid-2020. Employment moved above its pre-pandemic level in Q4 2021, and rose again in Q1 and Q2 of this year. Overall, it is estimated there are over two million more people in employment now, than before the pandemic. In contrast, both US and UK, employment levels have been slower to recover. Tight conditions are contributing to increased labour costs. The latest data which is for Q1, shows that wages rose by 3.3% on an annual basis in the quarter, although the data remain somewhat distorted by base effects.

The Eurozone economy is now facing a very challenging period. There are clear signs that economic activity is slowing in Q3, while at the same time, inflation has continued to increase by more than anticipated. Surveys of industry and consumers are indicating a contraction in activity. The war in Ukraine will continue to weigh on economic activity both directly and indirectly, by negatively impacting trade flows, and by reducing real incomes through higher inflation. The risks of a recession have increased substantially also, given Russia has stopped supply gas through the Nord Stream 1 pipeline, and has threatened to cut-off Europe altogether. Meanwhile, monetary policy and financial conditions are tightening. The ECB staff projections released today are for GDP to grow by 3.1% this year, before slowing to 0.9% in 2023, and 1.9% in 2024.

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