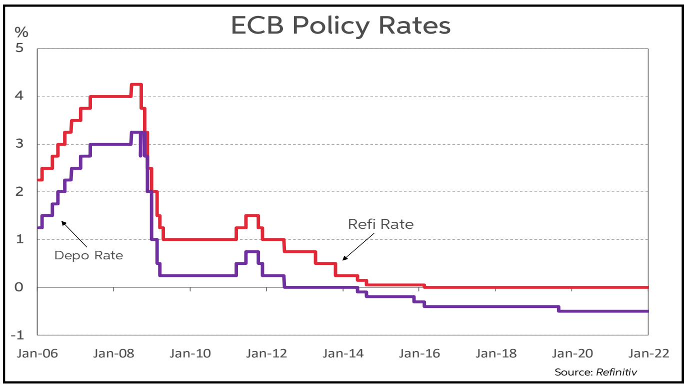
ECB Watch

AIB Treasury Economic Research Unit

3rd February 2022

ECB opens door for rate hikes later this year as inflation surges

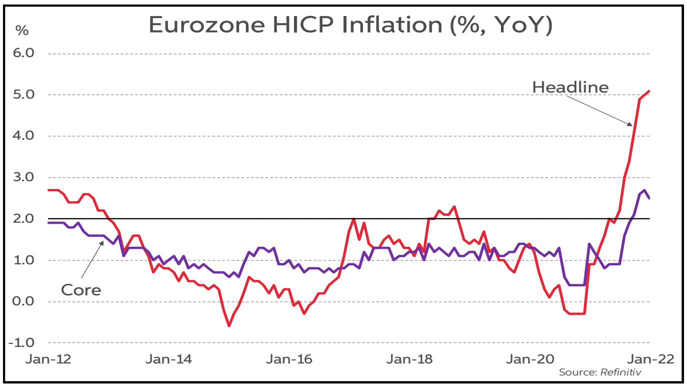
The February meeting of the ECB's Governing Council saw policy left on hold. This was no surprise as at its previous meeting in December, the central bank set out its broad policy agenda for 2022. **The quantity of bond purchases under its QE programme is being scaled back significantly.** The Pandemic Emergency Purchase Programme (PEPP) will conclude in March. Meanwhile, monthly bond buying under its other QE vehicle, the Asset Purchase Programme (APP) was set at €40bn during Q2, €30bn in Q3 and €20bn from October onwards for as long as necessary.



Crucially though, at today's post meeting press conference **the ECB did not continue to push back on market expectations of rate hikes in late 2022.** ECB President Lagarde refused to re-affirm its previous view that the conditions needed to be met to warrant rate hikes, were very unlikely to be in place this year. In other words, **the ECB opened the door for rate hikes later in the year.**

As noted, markets have not been convinced for some time that the ECB would keep rates on hold in 2022, especially with headline inflation having now risen to circa 5% and other central banks gearing up for a series of rate increases this year. Futures contracts continued to harden in recent weeks, starting to price in 20bps in ECB rate hikes by end 2022, with another 50bps in hikes built for 2023. Contracts firmed even more on today's ECB meeting, and **markets are now expecting a rate hike could come as early as September, with official rates expected to be increased by 30bps by end year.**

The latest set of ECB inflation forecasts were published in December. These projected that headline inflation would average 3.2% in 2022 and 1.8% both in 2023 and 2024. Core inflation was forecast 1.9% in 2022, 1.7% in 2023 and 1.8% in 2024. The ECB has emphasised that the rise in inflation is largely due to much higher than expected energy prices.



The next set of macro forecasts are due in March, with clear upside risks to the December inflation projections given the renewed surge in energy prices over the winter. Indeed**, the ECB noted today that inflation has continued to surprise to the upside and is now likely to remain elevated for longer than previously expected.** We would also point out that the labour market is tightening more quickly than anticipated, with the unemployment rate in the Eurozone falling to a record low of 7% in December, compared to the ECB forecast that it will average 7.3% this year. Disruptions to supply chains are also lasting longer than anticipated. As a result, the ECB acknowledged in its statement today that the risks to the inflation outlook are tilted to the upside, particularly in the near term.

Greater clarity on the monetary policy outlook will be provided at the ECB's next policy meeting in March when it will be able to consider updated staff macroeconomic forecasts. **There is a clear risk that it will announce an acceleration of the tapering of its QE programme,** which could now be wound up in the third quarter. **Rate hikes could begin in the autumn**.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2021	2022	2023	2024
HICP	2.6	3.2	1.8	1.8
Real GDP	5.1	4.2	2.9	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $77.5 in 2022, $72.3 in 2023 and $69.4 in 2024.

Source: ECB December 2021

The markets were quite surprised by the change in tone today from the ECB on the rate outlook. **The euro rose by about 1% against the dollar and sterling, rate contracts firmed further and bond yields increased by around 10bps.**

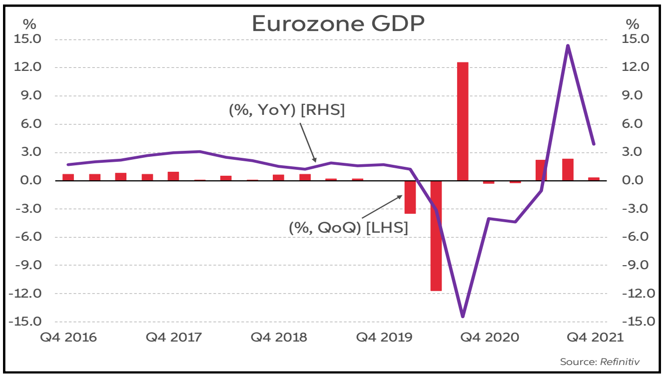
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

Robust recovery in 2021, but growth slowed in Q4

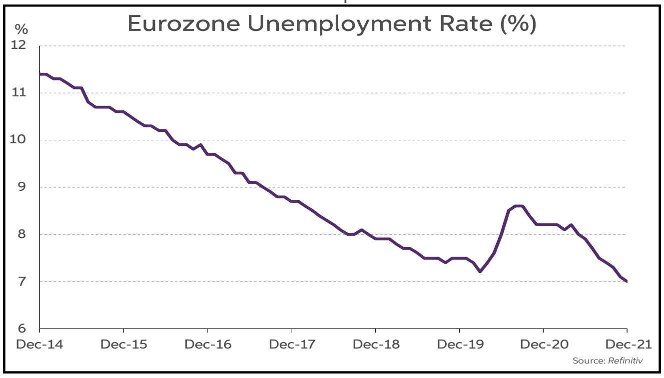
The economic recovery in the Eurozone slowed markedly in Q4. Preliminary data shows GDP grew by just 0.3% in the three months to December as the bloc grappled with the Delta and Omicron waves of Covid-19. Overall though, the Eurozone economy staged a robust rebound in 2021, having contracted by 6.4% in 2020. As the economy re-opened in Q2 and Q3, aided by supportive fiscal and monetary policy, GDP grew by 2.2% and 2.3%, respectively. The Eurozone economy expanded by 5.2% overall in 2021, meaning GDP roughly regained its pre-pandemic level in Q4.



However, the pace of recovery continued to vary among the large Eurozone economies in Q4. In Germany for example, the economy actually contracted by 0.7% in the final quarter of the year, as the country was hit earlier and more severely by the Delta wave of Covid-19. In contrast, France (+0.7%), Italy (+0.6%) and Spain (+2.0%) all recorded very solid growth rates in Q4. However, it is worth remembering that the German economy suffered a less severe contraction than the other three countries in 2020. In 2021, the recovery was uneven also. As a result, although French GDP was 0.9% above its pre-pandemic level in Q4, it was 0.7% and 1.4% below this level in Italy and Germany. Spain lagged even further behind, with the economy still 4% below its pre-Covid level.

The limited amount of available data for January suggest the economy has regained little momentum so far in Q1. The services PMI fell to 51.2 its lowest level since April as the Omicron wave adversely affected the sector. However, the manufacturing PMI rose slightly to 59.0 from 58.0, as new orders increased and supply chains issues showed tentative signs of improvement. Nonetheless, the EC sentiment indices all fell in January also. However, the survey data suggests that the economic impact from the Omicron wave was less severe than previous waves of Covid-19.

Turning to the labour market, the impact from the pandemic has been limited. Furthermore, the strong demand for labour since economies have re-opened during the summer has seen the jobless rate continue to trend lower. Indeed, the Eurozone unemployment rate edged down to a new record low of 7% in December. This compares to a 'Covid peak' of 8.7% in mid-2020, and is 0.1% below its pre-pandemic level. The strength of the labour market now, in part reflects the success of labour support schemes in shielding the jobs market (which have been funded to an extent by the EU SURE programme, to the tune of €90bn) throughout the pandemic.



Meanwhile, headline HICP inflation rose to 5.1% in January from an already record level of 5% in December. The latest increase was surprising given that base effects caused by the German VAT washed out of the annual rate. Energy prices, which are 28.6% higher year-on-year, continued to be the largest contributor to the rise in prices, but food prices also picked up in January. The ex-food & energy reading declined slightly, to 2.5% from 2.7%. Rising input prices and supply chain issues could continue to put upward pressure on the core rate in the coming months. At the press conference today, President Lagarde noted that the upside risks to inflation have increased. The latest forecasts from the ECB show headline inflation averaging 3.2% in 2022, before falling back to 1.8%, in both 2023 and 2024. We expect to see upward revisions to these projections when the ECB forecasts are updated next month.

The Eurozone economic recovery is now in a more challenging phase. Growth was slowing even before the Omicron variant emerged, and has regained little momentum so far in 2022. Inflation has also continued to increase by more than anticipated. However, the economy performed better than expected in 2021. The labour market is also on a much firmer footing. Looking ahead, household spending could be a key driver of growth if the large build-up of savings in 2020-21 are run down somewhat. Businesses and economies have also become better able to cope with the pandemic and restrictions on activity, with vaccines a major help in countering Covid-19. Monetary policy is set to remain very accommodative. The latest staff projections show that the ECB expects GDP to grow by 4.2% this year, and by 2.9% in 2023. **The IMF is forecasting that the Eurozone will grow by 3.9% and 2.5% in 2022 and 2023, respectively. Thus, the economy is expected to continue performing well in the next two years.**

AIB Treasury Economic Research Unit

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit