ECB Watch

AIB Treasury Economic Research Unit

AIB

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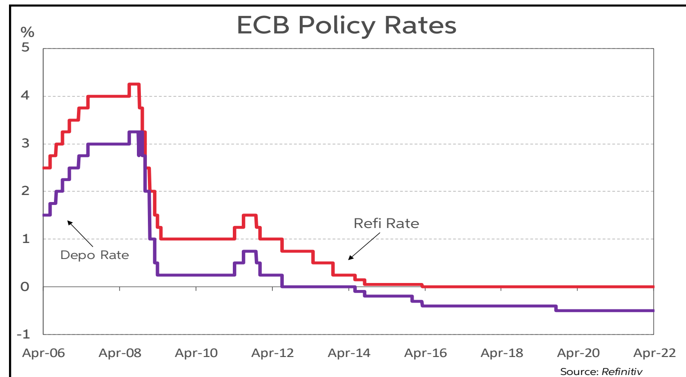
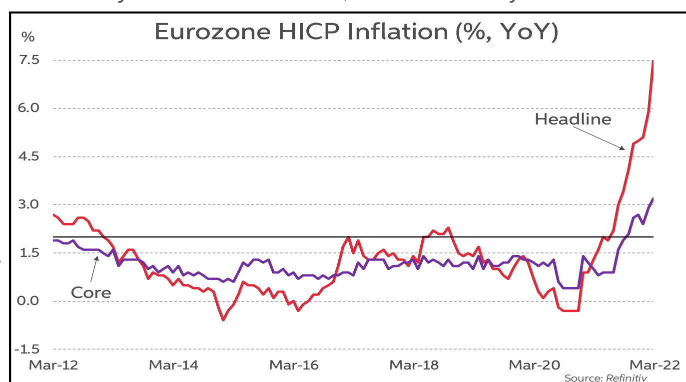
Soaring inflation increases pressure to tighten policy

The April meeting of the ECB's Governing Council was held against the backdrop of inflation in the Eurozone rising to 7.5% in March and expected to head even higher in the next couple of months. Pressure is growing for monetary policy to be tightened soon in response to growing risks to price stability. Nevertheless, the ECB, as expected, **kept policy on hold today and also refrained from shifting to a more openly hawkish stance**.



The ECB announced at its last policy meeting in March a quicker end to its asset purchases than previously envisaged, which are to now conclude during Q3. It stuck to this new timetable today, stating that **the data published since its last meeting reinforce its expectation that QE should be concluded in the third quarter.** In the lead up to this, the bond buying schedule under its Asset Purchase Programme will amount to €40bn in April, €30bn in May and €20bn in June, as indicated by the ECB at its previous meeting.



The ECB kept its key interest rates unchanged today. However, **there has been a marked hardening of rate hike expectations in the past month.** Rates are now expected to be increased by close to 70bps by end year and a further 120bps during 2023. This would take the key deposit rate up to around 1.4% from its current level of –0.5%. This is some 100bps higher than at the time of the last ECB meeting in March.

In the press conference, President Lagarde faced a number of questions on the inflation outlook and the need for earlier monetary tightening, in particular the timing of rate hikes. The ECB repeated its guidance that any changes to its interest rates will take place some time after the end of net asset purchases. It also again indicated that the pace of rate increases would be gradual.

Some ECB policymakers have been arguing for an earlier end to bond purchases to prepare the ground for rate increases commencing this summer, especially with rate hikes already underway in a number of other countries. The **ECB President indicated today that net asset purchases could end as early as July and that rate hikes beginning some time after meant anywhere from a week to several months.** The ECB emphasised that in the current highly uncertain environment, it will maintain optionality, gradualism and flexibility in the conduct of monetary policy. It will decide on the exact timing for the conclusion of asset purchases at its next meeting in June.

The ECB statement today acknowledged that the upside risks to inflation have intensified, especially in the near-term. It also noted that price rises have become more broad-based. This suggests that there are upside risks to the ECB's inflation forecasts published only last month. Headline inflation was forecast to average 5.1% in 2022, 2.1% in 2023 and 1.9% in 2024. Updated macro forecasts from the ECB will be published at its next policy meeting in June.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2021	2022	2023	2024
HICP	2.6	5.1	2.1	1.9
Real GDP	5.4	3.7	2.8	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $92.6 in 2022, $82.3 in 2023 and $77.2 in 2024.

Source: ECB March 2022

Markets scaled back their rate hike bets slightly following the ECB policy statement today, with small declines in short-dated bond yields. Meanwhile, the euro lost ground, falling below $1.08 against the dollar and 83p versus sterling. However, **market expectations for a series of rate hikes starting in September and lasting until end 2023 remain firmly in place.**

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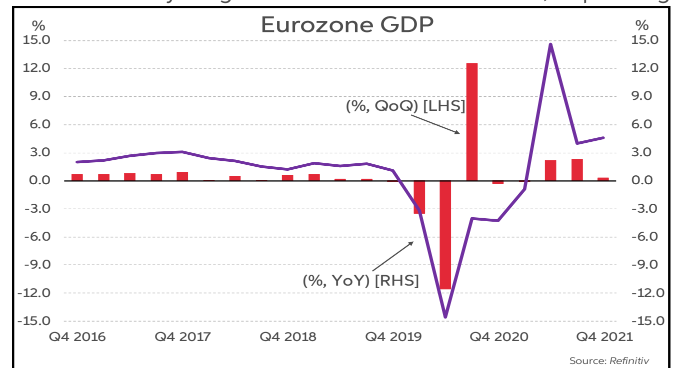
War in Ukraine to weigh on Eurozone recovery

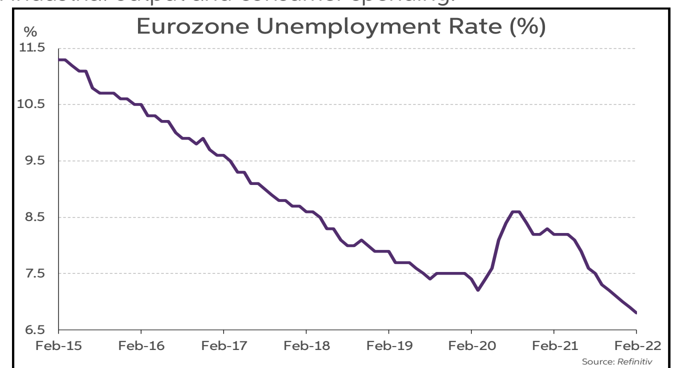
Growth in the Eurozone decelerated markedly to 0.3% in Q4 2021, as the bloc grappled with the Delta and Omicron waves of Covid-19. Overall though, the Eurozone economy staged a robust rebound in 2021, expanding by 5.3%. As a result, Eurozone GDP was 0.2% above its pre-pandemic level in Q4. Regarding the underlying breakdown, growth in Q4 was driven by an increase in investment. Gross fixed capital formation rose by 3.5% in the quarter, contributing 0.7 percentage points (p.p.) to the total. Government spending added a further 0.1 p.p. to GDP. Household consumption declined, clipping 0.3 p.p. from output. Net trade subtracted 0.6 p.p. from growth. However, this was offset by a rise in inventories which boosted GDP by 0.3 p.p..



Survey data suggest the economy regained some momentum during the first quarter. Having declined in December (53.1) and January (51.1), the services PMI rebounded in February (55.5) and March (55.6). Meanwhile, the manufacturing PMI remained firmly in expansion mode throughout the opening months of 2022 printing, at 58.7, 58.2 and 56.5, respectively, in January, February and March. However, consumer confidence plunged to –18.7 in March, its lowest level since April 2020. Industrial sentiment also declined in the month, falling to its lowest level since March 2021. Concerns regarding higher input costs and prices charged to customers, which were already rising, have been amplified by the war in Ukraine, and are weighing on sentiment. Services sentiment improved for the third-month running though, as the sector remained buoyed by a further re-opening of the economy in March.

The limited amount of available hard data though, have not been as strong as the PMI surveys, even before the impact of the war in Ukraine. Industrial production was unchanged in January, following a decent recovery a the end of 2021. Meanwhile, retail sales have increased by 0.2% and 0.3% in January and February. However, sales were still 1.8% below their pre-Omicron wave level from last November. It is important to note also that the data do not yet capture the impact from the invasion of Ukraine. The war is likely to lead to further supply chain issues on top of even higher inflation, which will weigh on both industrial output and consumer spending.

In terms of inflation, preliminary data indicate headline HICP jumped to 7.5% in March from 5.9% in February. Energy prices, which remained the main contributor to inflation, were a whopping 44.7% higher year-on-year. Worryingly, March's increase was broad based, with prices rising in all of the major categories. The ex-food & energy annual rate rose to 3.2% from 2.9%. The conflict in Ukraine has placed even more upward pressure on a large swathe of commodity prices, which will likely contribute to higher inflation for longer in the Eurozone than previously anticipated. Indeed, the latest forecast from the ECB for headline inflation to average 5.1% in 2022 already seems out of date given the surge in inflation in March.



Meanwhile, the labour market has performed very strongly since last summer. Indeed, the unemployment rate edged down to a new record low of 6.8% in February, from a "Covid peak" of 8.7% in mid-2020. Perhaps even more impressively, employment moved above its pre-pandemic level in Q4 2020. This is in contrast to both the US and UK, were employment has been slower to recover.

The Eurozone economy is now facing a challenging period despite relatively strong PMI data in early in 2022. Inflation has continued to increase by more than anticipated, in part, due to the conflict in Ukraine. The war in Ukraine will weigh on economic activity both directly and indirectly, by reducing trade flows between the Euro-area and Russia, and by reducing real incomes through higher inflation. This will weigh on consumption. Increased uncertainty may dampen investment in the near-term also. In a more ominous scenario, if the EU were to stop importing Russian energy, particularly natural gas, the threats of a recession would rise. It should be noted though, that the economy performed better than expected in 2021. The labour market is also on a much firmer footing. The latest ECB staff projections show that the central bank expects GDP to grow by 3.7% this year, before falling back to 2.8% in 2023 and 1.6% in 2024 respectively. However, we think these forecasts may be revised lower next month.

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