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ECB HEADS TOWARDS SLOW POLICY NORMALISATION IN 2023

POLICY RATES TO REMAIN WELL BELOW NEUTRAL

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SUMMARY

› The relentless rise in inflation has led most central banks to start normalising their policy stances. The ECB stands out as more dovish, with good reasons, but the patience of the central bank's hawks is likely to wear thin as underlying inflation pressures continue to build over coming months.

› We have brought forward our forecast of ECB rate hikes, including two 25 basis point rises in March and June 2023, bringing the deposit rate back to zero. This would result in a less accommodative, but not a restrictive policy stance. We also expect the ECB to confirm that the TLTRO special interest rate will not be extended beyond June 2022, while the tiering multiplier should be increased.

› The ECB's main challenge will be to engineer tighter financial conditions but not an unwarranted tightening. Ending quantitative easing by December 2022 may require the ECB to implement new contingency tools allowing for a resumption of net asset purchases in case of a sharp widening in peripheral spreads.

When facts change, what do you do ECB?

Six months ago, the ECB announced the results of its strategy review and committed to keeping an "especially forceful or persistent" monetary stance as the economy was stuck at the lower bound. Inflation had started to rise but was thought to be transitory. Since then, the Fed and other central banks have left the 'transitory' camp and are trying to get ahead of the inflation curve.

To be sure, there is no reason for the ECB to follow the Fed on a swift normalisation path of the monetary stance. The euro area medium-term inflation outlook still looks subdued, and the economic cycle lags the US's in every dimension – from the fiscal response to real activity, inflation and, crucially, wage growth.

True, the impact of the Omicron wave on economic activity has been less severe and shorter than feared. ECB Chief economist Philip Lane highlighted in a recent interview that "there's less concern about Omicron than we had in December". Economic activity has lost momentum following the rebound in Q2/Q3 2021, mainly driven by weakness in the services sector, but business confidence surveys has stabilised in the manufacturing sector as supply-chain disruptions have started to ease. Geopolitical risks have risen with the Russia/Ukraine tensions, but some other risks have eased, including in Italy with the reappointment of Sergio Mattarella as President of the Republic. In all, the ECB is likely to maintain a broadly constructive view on the growth outlook.

Meanwhile, **inflation has been higher and more persistent than expected, but this surge has been mainly driven by energy costs and supply-side constraints rather than by demand**. Inflation surprised to the upside again in January, despite the negative base effect of the German VAT, although this was due to higher energy and transportation costs as well as a few services prices and statistical effects. The ECB will focus on upside risks in its communication, and upward revisions to staff projections are very likely again in March. But, the bar for above-target inflation to prove persistent, and for the ECB to effectively tighten policy, remains high.

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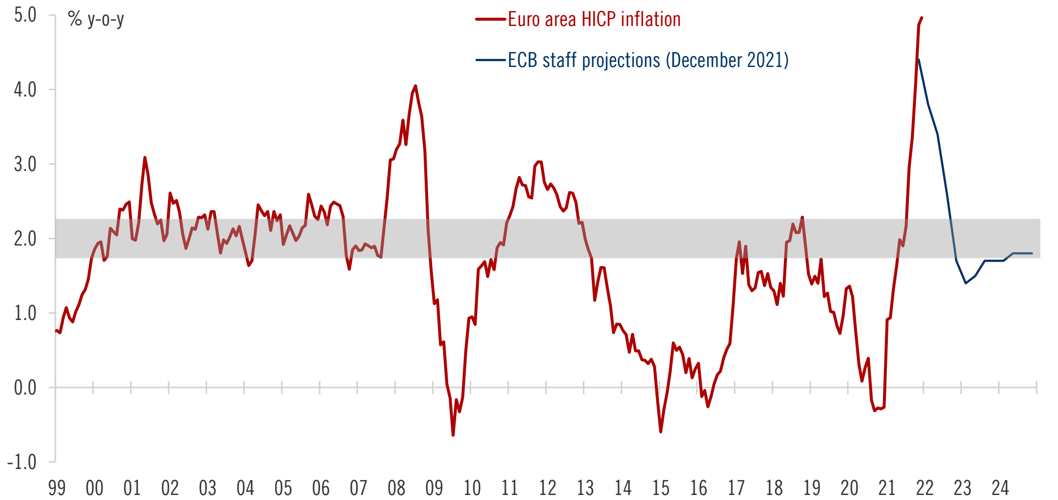
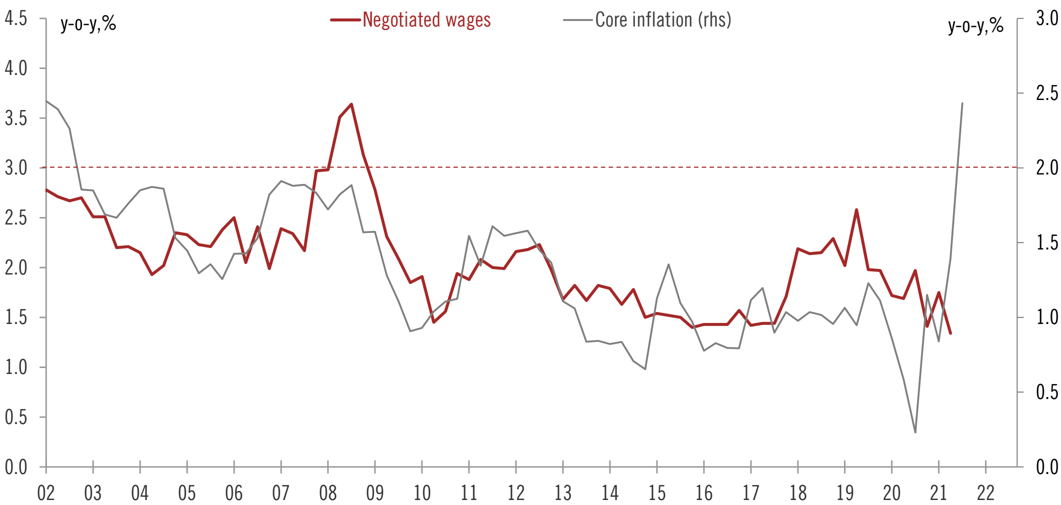
CHART 1: EURO AREA HICP INFLATION AND ECB STAFF PROJECTIONS



Source: PWM - AA&MR, Eurostat, ECB

The main indicator to watch will be wage developments in 2022. Starting from a very low base below 2%, **wage growth is likely to pick up substantially over the coming quarters** on a combination of diminishing labour market slack, higher workers' bargaining power, an increase in the minimum wage in several countries, and a pass-through of higher inflation to nominal compensation. Philip Lane made it clear that an increase in wage growth would be needed, in excess of what the ECB was already discounting, for inflation to stabilise around 2% over the medium term. Specifically, Lane mentioned wage growth of around 3%, with productivity around 1%, to be consistent with the ECB's 2% inflation target. We think that **wage growth is likely to pick up to 3% this year, but it remains to be seen whether we will see a sustained acceleration beyond that level**.

CHART 2: EURO AREA NEGOTIATED WAGES AND CORE HICP INFLATION



Source: PWM - AA&MR, Eurostat, ECB

Germany will be monitored particularly closely. The latest rounds of wage negotiations have not led to materially higher wage settlements, barely above 2% on an annual basis on average. Following the inflation spike and the ongoing improvement in labour market conditions, wages should catch up… or they may never will.

From ultra-accommodative to very accommodative

The ECB is unlikely to overreact to current inflation prints unless the medium-term outlook changes. Notwithstanding the change in personnel, the 2011 policy mistake, when the ECB hiked in a double-dip recession, followed by a decade of inflation undershooting, is still in everyone's mind. That alone should call for caution, along with the conclusion of the strategy review and the strict conditions for lift-off.

Let's not forget that policy normalisation, including a one-off hike in the deposit rate, was discussed during the so-called "Euroboom" of 2017. Yet, the ECB failed to hike rates during boom years, so why should they do so as a response to surging energy prices and supply-side constraints today? President Christine Lagarde recently said that rate hikes in the current context would do no good and would not fix the inflation problem given the lags in monetary policy transmission.

Either way, the pressure will continue to mount. Inflation is likely to run hotter for longer than expected. Wage growth will likely pick up sharply. Inflation expectations look well-anchored. Meanwhile politics look fairly stable, the NGEU stimulus is being deployed, the fiscal impulse looks better than in the US. All this should increase the ECB's confidence that inflation will eventually stabilise at 2% in the medium term, while the hawks will be worried about upside risks.

Patience, prudence, and forward guidance

The ECB's main challenge will be to engineer tighter financial conditions but not an unwarranted tightening. However gradual and cautious, policy normalisation will require a combination of strong data, stable financial markets, rising foreign demand for governments bonds, consistent communication, and probably a great deal of luck.

We expect the ECB to bring its deposit rate back to zero in two 25bp rises in March and June 2023, before making a pause in H2 2023. To do so, forward guidance could be tweaked but **net asset purchases will have to stop by December 2022 either way**. This could prove particularly challenging as the euro area bond market has long been operating under the assumption that the ECB would buy a large part of government bond net supply for the foreseeable future, keeping risk premia in check.

The ECB might tolerate a gradual rise in bond yields as long as the economic outlook keeps improving, but not an abrupt move higher. The problem is that the policy tools aimed at preventing an unwarranted widening in peripheral spreads are likely to be less credible and less efficient in the normalisation phase. Therefore, **ending QE by December 2022 may require the ECB to implement new contingency tools allowing for a resumption of net asset purchases in case of a sharp widening in peripheral spreads**.

Meanwhile, we also expect the ECB to confirm the end of the TLTRO discount at its 10 March meeting, effectively raising the TLTRO minimum interest rate to -0.50% from June, in line with the deposit facility rate. The ECB should also increase the tiering multiplier in order to exempt more bank reserves while excess liquidity starts to decline later this year.

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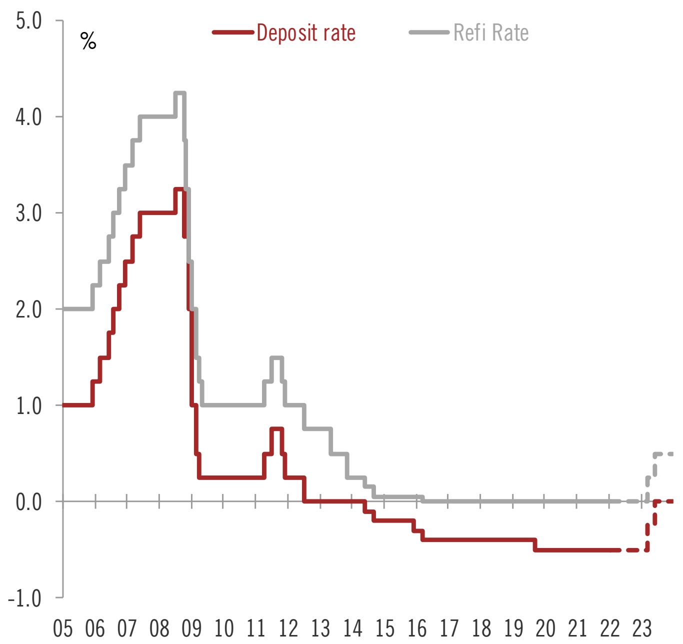
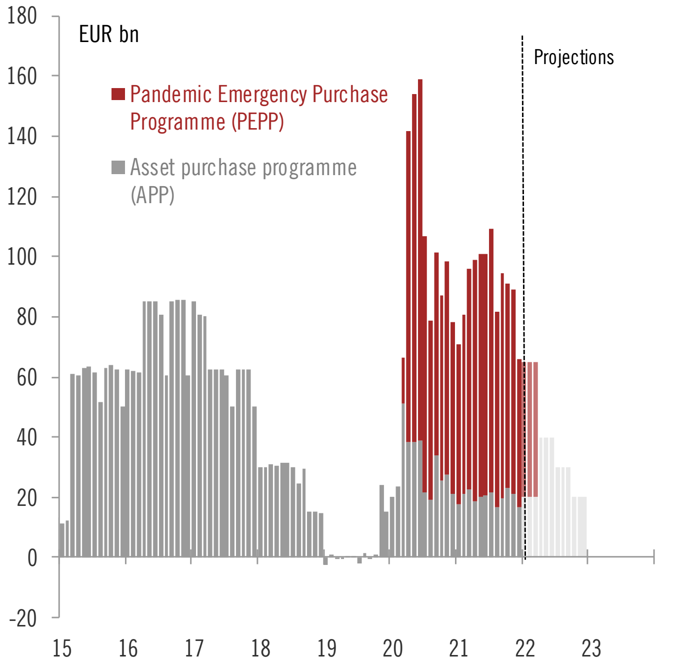
CHART 3: ECB – MAIN POLICY RATES, INCLUDING PROJECTIONS



Source: PWM - AA&MR, ECB

CHART 4: ECB – ASSET PURCHASE PURCHASES, INCLUDING PROJECTIONS



Source: PWM - AA&MR, ECB

Beyond that, we do not think that the ECB will be in a position to shift its monetary stance into restrictive territory for the foreseeable future (if ever). There is considerable uncertainty about the level of the neutral rate, but it is likely to be significantly lower than its historical average, probably below 2% in nominal terms. Rate hikes could resume at a slower pace in 2024, but we forecast the ECB's main policy rates to peak at around 1% over the medium-term.

In terms of the broader policy mix, **the biggest wild card on the horizon will be a potential reform of the European fiscal rules**. French President Emmanuel Macron called a summit in March to discuss the topic, with the hope of providing flexibility and visibility to member states when it comes to negotiating their budget plans with Brussels. There might be a unique window of opportunity for European governments to agree on such reform in 2022. Its economic impact would depend on the extent to which the flaws of current fiscal rules are being addressed. But, a political agreement could be a game-changer for the ECB, which has been calling for it for ages, reducing so-called fiscal dominance in the euro area.

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