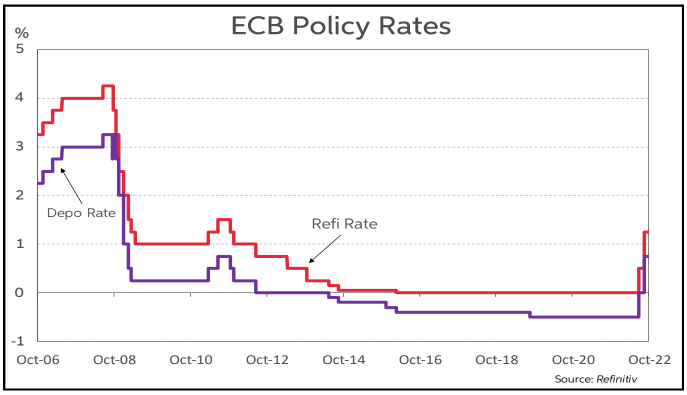
ECB Watch

AIB Treasury Economic Research Unit

27th October 2022

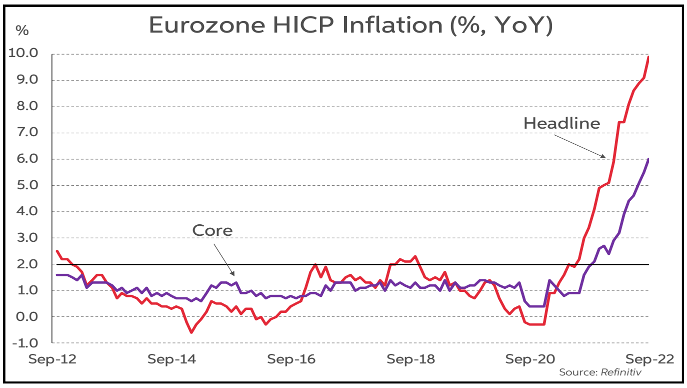
Markets scale back rate hike expectations on dovish ECB Signal

The October meeting of the ECB's Governing Council saw the central bank deliver its second consecutive 75bps hike in interest rates, as markets had anticipated. The key deposit rate rises from 0.75% to 1.5%, while the refi rate is being increased from 1.25% to 2%. President Lagarde indicated that the ECB are not done yet, and there is more ground to cover in terms of raising rates. However, in a key line in the meeting statement, **the ECB indicated that "it has made substantial progress in withdrawing monetary policy accommodation".**



The markets interpreted this as a dovish signal and scaled back their expectations on the scale of further rate hikes. Futures contracts now see rates peaking at 2.75% next year rather than 3% ahead of the meeting. Benchmark two and ten year bond yields fell by circa 20bps. President Lagarde stated that rate decisions will be made on a meeting by meeting basis and would be very much data dependent, taking into consideration in particular the outlook for inflation and the risks of a recession. However, she refused to give any indication of how many more rate hikes are likely to be delivered by the ECB in this cycle.

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 HICP rate picked up to 9.9% in September, while the core rate accelerated to 6.0%. The ECB's latest inflation forecasts were contained in its September macro projections. It sees 2022 inflation averaging 8.1%. For 2023 it expects inflation to average 5.5%, before falling to 2.3% in 2024.



President Lagarde also referenced the risks of a recession. Growth was stronger than expected in the first half of the year, but the economy is now clearly losing momentum. In its September macro forecasts, the ECB projected GDP growth of 0.9% for the Eurozone in 2023. President Lagarde indicated today that the downside risks to this forecast have increased in the past month. However, she also noted that there have been some positive developments recently, such as announcements of fiscal supports and a marked fall in gas prices.

There was no reference to any plans for Quantitative Tightening (QT) in today's meeting statement. The ECB President indicated that the topic was not discussed, but the **key principles of QT would be outlined at its next meeting in December.** There were other policy changes announced today. The remuneration of minimum reserves will be at the ECB's deposit rate going forward, rather than the higher refi rate. **It is also adjusting the interest rate applicable to its third targeted longer-term refinancing operations (TLTRO 3).** It is raising the current very attractive borrowing rates available under this facility, but will offer banks additional voluntary early repayment dates.

The final ECB meeting of the year takes place on December 15th. Futures contracts suggest that the market is expecting a 50bps of a rate hike This would see the Deposit rate end 2022 at 2%. Further out, the market is anticipating two 25bps hikes in the opening quarter of 2023, followed by one final 25bps hike later in the year. If these materialise, it would result in the depo **rate peaking at 2.75% in H2 2023.** Today was the second pivot by a central bank in the past 24 hours. Last night, the Bank of Canada surprisingly dialled back its hiking pace, lifting its benchmark by 50bps to 3.75%. BoC Governor Tiff Macklem also indicated that "this tightening phase will draw to a close". There will be much interest to see if the Fed and BoE also pivot at their policy meetings next week as well.

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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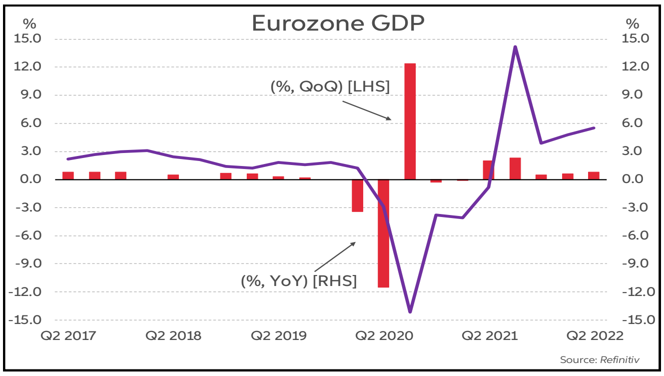
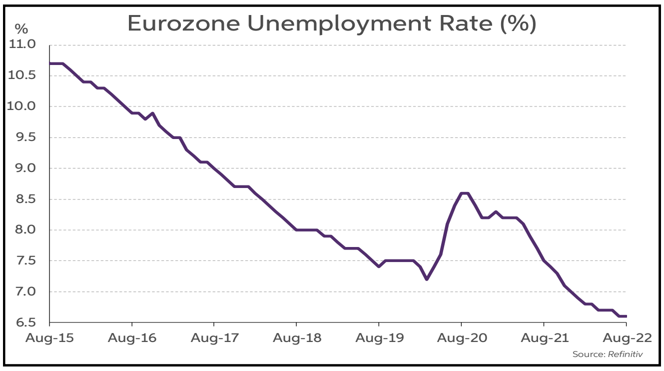
Eurozone outlook downbeat as inflation surges



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, activity has slowed in the third quarter. Retail sales fell by 0.4% in July, and by 0.3% in August. Non-food sales in stores have been particularly weak in recent months. Overall retail sales were circa 3.2% below their peak level from November last year at the end of August. Meanwhile, industrial production has been quite volatile, largely due to multinational activity in Ireland. Industrial output plunged by 2.3% in July, before rebounding by 1.5% in August. However, German industrial production softened markedly in July and August.

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. Similarly, the services PMI fell into contraction territory in August, before deteriorating further in September. Overall the index averaged 49.9 in Q3, down from 55.6 in Q2. Meanwhile, the EC sentiment index, which has been trending lower since the onset of the war in Ukraine continued to weaken in the third quarter, falling to its lowest level since August 2020 in September. Elsewhere, consumer confidence fell to its lowest level on record in September, as surging inflation weighed on real household incomes. **The limited amount of survey data available for October suggest the economy continues to weaken.** The Eurozone flash PMIs moved lower across the board in October, while consumer confidence remained within touching distance of its all-time low from September.



In terms of inflation, headline HICP jumped to 9.9% in September, from 9.1% in August. Worryingly, inflation has continued to become more broad based, with the ex-food & energy rate rising sharply to 6%, from 5.5%. However, the large increases in the main inflation metrics in September were largely driven by the conclusion of subsidised public transport tickets in Germany. Although, energy inflation also ticked higher in the month, the recent decline in wholesale gas prices should feed through to consumer prices in the months ahead. 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, and remained there in August. Employment moved above its pre-pandemic level in Q4 2021, and rose again in H1 of this year. 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 data which is for Q2, shows that wages rose by 4.0% 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. Surveys of industry and consumers point to a contraction in activity. The war in Ukraine will continue to weigh on economic activity both directly and indirectly, in particular by reducing real incomes through higher inflation. The risks of a recession have increased as monetary policy and financial conditions are tightened further. However, the recent sharp downward trend in wholesale energy prices and the blocs ability to reach its storage goals ahead of time, suggest the Eurozone is coming into the winter in better shape than had been feared. The outlook for 2023 though, remains downbeat The IMF expects GDP to rise by 3.1% this year before slowing to just 0.5% in 2023. Similarly, the latest ECB staff projections are for growth of 3.1% this year, before slowing to 0.9% in 2023, and 1.9% in 2024.

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