

Soaring inflation forces ECB into policy tightening

The June meeting of the ECB's Governing Council marks a major turning point in monetary policy in the euro area. The ECB announced that net asset purchases under its QE programme would end on July 1st. Meantime, rates will start to be hiked from next month also, in the first tightening of policy in over a decade. The ECB said it would raise its key interest rates by 25bps at its July 21st policy meeting.

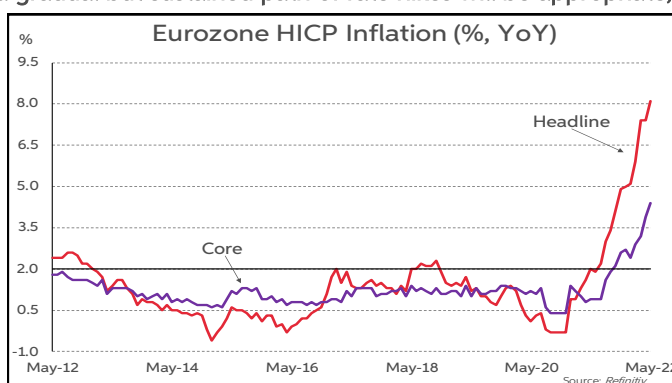
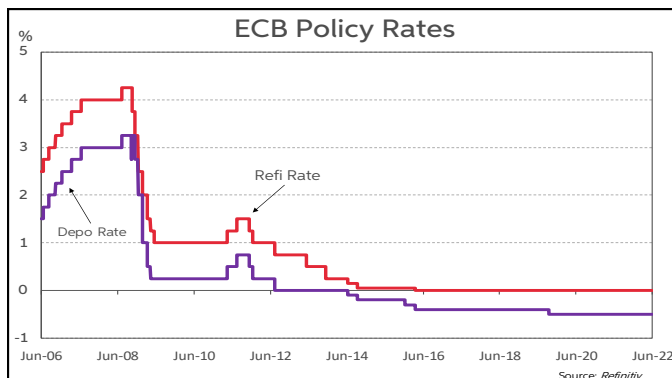
It expects to increase interest rates again at the following policy meeting in September and indicated that a larger hike than 25bps may be appropriate then, depending on the outlook for inflation. The bar does not appear to be that high for a bigger hike as the ECB signalled the medium term inflation outlook would need to improve to avoid such a move. In particular, inflation would need to be seen as returning to its 2% target or below by 2024. Beyond September, the ECB anticipates that a gradual but sustained path of rate hikes will be appropriate, with the pace depending on the expected future course of inflation. It suggests that if the medium-term outlook for inflation is still above 2%, then further rate hikes of more than 25bps will be on the cards.

The ECB struck a more hawkish than anticipated tone today, with the central bank now qualifying previous guidance that the pace of tightening would be gradual and modest. Thus, futures contracts hardened and bond yields rose sharply following the ECB announcements, especially in peripheral Eurozone markets. Rates are now seen as rising by 75bps in Q3 and close to a further 75bps in Q4. This would see the key deposit rate rise from -0.5% at present to almost 1.0% by end year. Rates are expected to be hiked by circa a further 100bps in 2023, taking them up to near 2% by the end of next year.

The reason for the hardening stance of the ECB is the deteriorating inflation picture. The HICP rate climbed to 8.1% in May. The updated quarterly ECB macro forecasts published today show marked upward revisions to inflation forecasts. The HICP rate is now projected to average 6.8% this year, up from the forecast of 5.1% made in March. Furthermore, inflation is expected to remain above target at 3.5% in 2023 and 2.1% in 2024 compared to the March forecasts of 2.1% and 1.9% for both years. Oil prices are assumed to fall back somewhat in 2023-24.

The ECB has also lowered its growth forecasts for 2022 and 2023 to 2.8% and 2.1%, respectively, from 3.7% and 2.8% previously. However, the GDP forecast for 2024 was upped from 1.6% to 2.1%. We would see significant downside risks to the 2023 and 2024 growth forecasts, given the deteriorating global backdrop, high inflation and tightening of monetary policy and financial conditions.

A weaker than expected growth performance in 2023 could help inflation to return to target over the medium term, not withstanding that most of the spike in inflation is due to external factors that have driven global commodity prices sharply higher. Thus, while significant policy tightening is certainly on the cards for the second half of 2022, rate hikes on the scale priced in by markets for 2023 may not materialise if growth proves weaker than expected by the ECB, which combined with some easing in oil prices helps bring inflation back to target.



ECB Macroeconomic Forecasts for the Euro Area

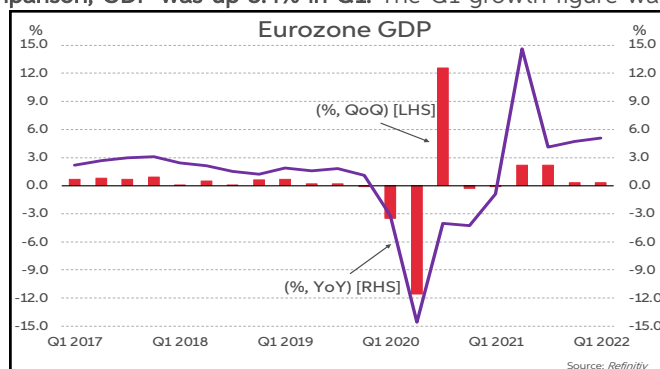
(%)	2021	2022	2023	2024
HICP	2.6	6.8	3.5	2.1
Real GDP	5.4	2.8	2.1	2.1

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$105.8 in 2022, \$93.4 in 2023 and \$84.3 in 2024.

Source: ECB June 2022

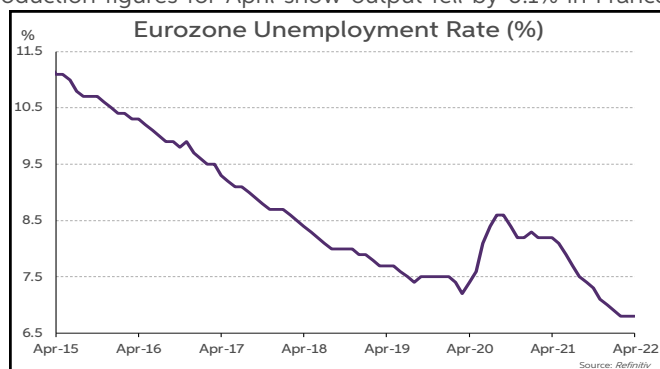
Risk of a recession mounts as inflation surges

The Eurozone economy grew by 0.6% in the first quarter of 2022, which followed a subdued 0.2% growth rate in the final quarter of last year. On a year-on-year comparison, GDP was up 5.4% in Q1. The Q1 growth figure was boosted by a very strong 11% rise in Irish GDP. More generally, COVID restrictions continued to impact activity over the winter months, with rising inflation also weighing on spending power. In terms of the underlying breakdown, the key drivers of growth in Q1 were net trade and stockbuilding. Exports rose by 0.4% in the quarter, contributing 0.2 percentage points (p.p), while imports fell by 0.6% (adding 0.2 p.p). Inventories added a further 0.6pp to growth. In contrast, domestic spending was a drag on growth. This included consumption contracting by 0.7% in the quarter, knocking 0.3pp from GDP.



Survey data have been mixed so far in Q2, against the backdrop of uncertainty on the economic outlook, most notably stemming from the War in Ukraine. The services PMI was at 56.1 in May, as the sector continued to experience a strong rebound following the removal of COVID restrictions. The manufacturing PMI, though, fell in May for a fourth consecutive month to 54.6, its lowest level November 2020, though it remains well in expansion territory. Meanwhile, the EC economic sentiment indices have been quite weak since the war in Ukraine started. The headline index fell to 106.5 in March, its lowest level since April 2021 and has remained near this mark so far in Q2. Consumer confidence has also plunged, falling to its lowest level since the onset of the pandemic in March and remaining at that level in both April and May.

The limited amount of available hard data for Q2 have generally been disappointing. Retail sales fell by 1.3% in April. However, retail sales account for less than half of Eurozone consumption, and spending on services likely continued to improve in April and May. Industrial production figures for April show output fell by 0.1% in France after a 0.4% decline in March. Meanwhile German output rose by 0.7%, however, this followed a 3.7% fall in March. The data indicate that industrial production continues to struggle amid increasing costs and ongoing supply chain difficulties.



In terms of inflation, preliminary data indicate headline HICP jumped to 8.1% in May from 7.4% in April. Energy prices, which remained the main contributor to inflation, were 39.2% higher year-on-year. Worryingly, inflation has become more broad based in recent months, with prices rising in all of the major categories. The ex-food & energy annual rate rose to 4.4% from 3.9% in April. The conflict in Ukraine has placed continued upward pressure on a large swathe of commodity prices, which will likely contribute to higher inflation for longer in the Eurozone than previously anticipated. The latest ECB inflation forecasts show inflation averaging 6.8% in 2022 and 3.5% in 2023.

Meanwhile, the labour market has performed very strongly since last summer. Indeed, the unemployment rate was at a new record low of 6.8% in April, down from a "Covid peak" of 8.7% in mid-2020. Perhaps even more impressively, employment moved above its pre-pandemic level in Q4 2021, and rose again by 0.6% in Q1 of this year. This is in contrast to both the US and UK, where employment has been slower to recover.

It is clear the Eurozone economy is now facing a challenging period. Inflation has continued to increase by more than anticipated, in part, due to the war in Ukraine. The war 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. If the EU were to stop importing all types of Russian energy, the threat of a recession would rise. Meanwhile, monetary policy and financial conditions are tightening. The labour market, though, is on a firm footing. The latest ECB staff projections show that the central bank expects GDP to grow by 2.8% this year, slowing to 2.1% in both 2023 and 2024. The OECD is forecasting growth of 2.6% this year, falling to 1.6% in 2023. We are more inclined to believe the 2023 OECD forecasts given the numerous headwinds facing the economy.

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