Focal Point

ECB: Case for policy normalisation gets stronger

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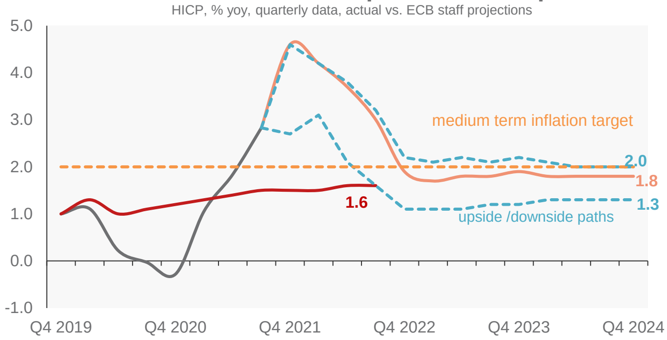
Our Focal Point series explores topical issues on macro, markets and investment

- The pandemic's grip on euro area activity is weakening while headline inflation will remain well above target for most of 2022 due to high energy prices and persisting supply bottlenecks. In contrast, underlying inflation is set to fall below the 2% threshold again and to stay there.
- Looking beyond 2022, with inflation expectations now broadly at target there is mounting indication that the low inflation environment of the past decade is over. The green and demographic transition are key factors implying higher underlying price pressure and then significantly less need for policy support.
- The ECB will need to withdraw stimulus after the PEPP's end in 2022 while not jeopardizing the recovery by keeping financing conditions still favourable. It already announced a smooth reduction of QE over 2022. Therefore, due to the new strategy, near-term downside risks (e.g. pandemic, China, geopolitics) and because of credibility reasons we continue to deem a 2022 rate rise very unlikely.
- That said, Governing Council (GC) members see the inflation risks tilted to the upside. We now expect that higher energy prices and second-round effects in the 2022 wage negotiations trigger a first 20 bps rate hike already in June 2023.

Following a decade of fight against low inflation, the post-pandemic recovery, high energy prices and persisting bottlenecks pushed inflation strongly above target in 2021. Euro area inflation shot up to 5.0% yoy in December and for most of 2022 it is set to stay clearly above target. Medium term, the green transition and a shrinking labour force, as the baby boomers leave the labour market, will contribute to structurally higher inflation. Hence there are good reasons to expect that the low inflation environment will be over. The ECB will need to adjust its policy stance and GC members see the risks tilted towards a higher inflation path.

Risks tilted towards upside inflation path

HICP, % yoy, quarterly data, actual vs. ECB staff projections



Source: Datastream, ECB, GIAM calculations

We expect the ECB to proceed cautiously in order not to choke-off the recovery but look for an anticipation of the first deposit rate hike to 2023.

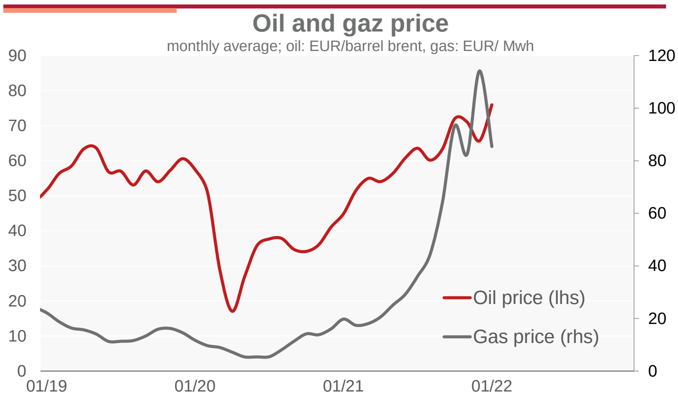
Underlying price pressure not yet easing

What makes the current situation so special is that there is a **broad-based increase in prices**, and not just concentrated in Covid-sensitive sectors. As of November 2021 only 2 out of 85 components (HICP on a 3-digit level) reported falling annual inflation whereas 47 saw numbers above 2.0%, something not seen for about ten years. And there is good reason to expect that even after the petering out of some base effects at the outset of the year (related to the temporary 2020 German VAT cut) underlying price pressure will moderate from the December 2.7% yoy reading but stay strong. In November 2021, producer prices soared by 23.7% yoy and import prices by 9.9% yoy, both the highest values in more than a decade. In order to restore margins firms have increased their prices as the PMI surveys show. Given this price pressure the **ECB adjusted its inflation outlook significantly to the upside** and in the December projection saw annual inflation at 3.2% in 2022 (up from 1.7% in September). Underlying inflation is set to average 1.9% (up from 1.4% in September) thereby coming close the medium-term target. That said, there are still upside risks to inflation in the offing.

Energy price risks: green transition and geopolitics

A significant upside risk to inflation emerges from energy prices that accounted for roughly half of the record-high December inflation rate. Looking ahead, there are further upside factors at work. With the recovery set to continue after an Omicron-induced winter soft patch demand will stay strong. But the **green transition is likely to cap** investment in fossil energy; constrained supply will thereby keep prices high. And renewable energy is not yet able to increase energy supply at the needed scale. In a recent speech GC member Schnabel made clear that the ECB is pretty aware of this issue, expects **energy to make a higher contribution to annual inflation than** the 0.3 pps **since the start of EMU** and concludes that the energy transition "*poses measurable upside risks to our baseline projection of inflation over the medium term.*"

The second factor in favour of higher energy price inflation is **geopolitics** amplifying the effects from the green transition. Gas is an important stopgap on the way to climate-neutrality. It has a weight of 20% in the HICP energy. Current future prices suggest that the gas price will fall by almost 50% within one year. However, apart from weather effects, increasing geopolitical tensions and especially the **Russian-Ukrainian tensions have the potential to keep gas prices high or to even increase them**.



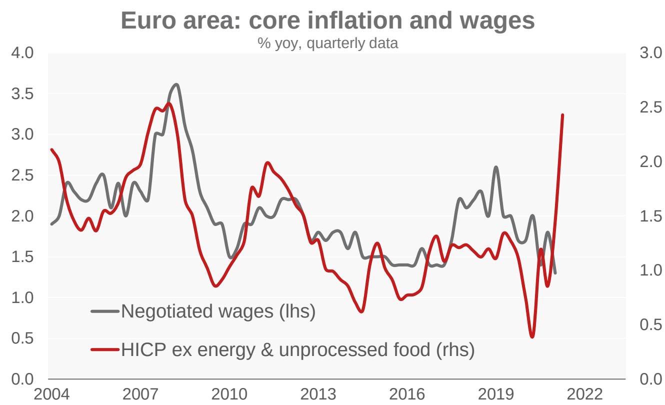
Source: Datastream, GIAM calculations

Labour market in good shape

What makes the current situation so special is that due to the various pandemic-related support measures the **labour market is currently in good shape**. The euro area unemployment rate of 7.2% (November 2021) is just a notch above the European Commission's estimated equilibrium level (with the NAWRU at 7.1% in 2022). Employment is also on an expansionary trajectory (+2.0% yoy in Q3/21) and surveys like the PMI indicate that it continues notwithstanding the winter soft patch in activity. Hence, unlike to other recoveries the remaining labour slack will disappear faster this time. Moreover, with the Baby Boomers increasingly leaving the labour market the **working-age population will shrink over the coming years**. Until 2024 it is set to recede by 1.2 mn persons (or 0.5%) compared to the pre-pandemic level. This increases the scarcity of labour and hints at higher than past wage growth over the medium term.

Current wage round a key signpost for the ECB

The current wage round will take a centre stage for the GC's inflation outlook. It will be a key signpost for second-round effect from the current inflation spike as various GC members like President Lagarde, Vice-President de Guindos, Schnabel and Chief Economist Lane made clear.



Source: Datastream, GIAM calculations

Negotiated wages were up by only 1.3% yoy in Q3/2021 (Q1 to Q3 average is 1.5%) and according to the latest EC forecast compensation per employee was up by 2.6% in 2021. We see **clear signs of a significantly higher wage growth in 2022**. Trade unions are demanding a compensation for last year's inflation surge. This concerns first of all the German economy where inflation averaged 3.1% yoy (higher than the euro area average of 2.6%) last year while negotiated wages advanced by only 1.7% yoy.

In Germany, wage demands for the 2022 round are at around 5% for twelve month (printing industry) **and 5.0-6.5%** (restaurants or *Nahrung-Genuss und Gaststätten*). Other trade unions will likely follow with similar demands. Moreover, the minimum wage rises against year-end 2021 by 11% in two steps (to 9.82 by Jan 1, 22 and 10.45 by July 1, 22) and there even is some willingness by the (together with Greens and Liberals) governing Social Democrats to increase it to 12 €/hour, as promised in the election campaign, already this year. The minimum wage covers about ¼ of the employees (according to WSI Tarifarchiv) and also serves as an anchor for sectoral minimum wages that are negotiated between employers and trade unions and finally declared as binding by the government.

We think that the **wage pressure in Germany might be outstanding compared to other countries but that wage growth will increase also in other economies** so that in the end it adds further upside pressure on inflation. This would be consistent with past experience. Just before the GFC started to unfold, in 2008 the euro area unemployment rate was at 7.6%, inflation at 3.3% and negotiated wages grew by 3.5%. ECB Chief economist Lane stated in a recent interview that wage growth above 3% would not be consistent with the ECB's inflation target.

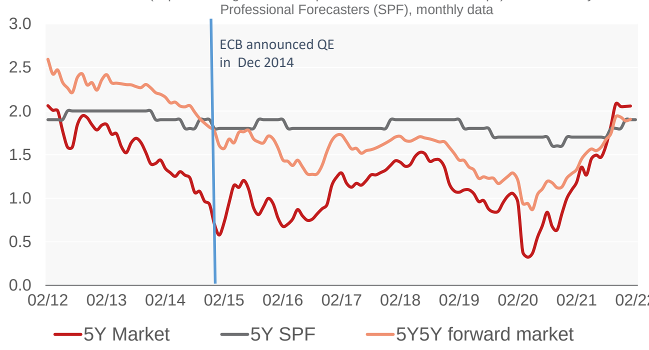
Inflation expectations now broadly at target

In the past the ECB would have welcomed higher inflation as a mean to push inflation expectations back to normal. However, at present its **preferred measures of inflation expectations are broadly in line with target**. Medium term (5Y) average inflation expectations by professional forecasters have recovered to 1.9% and market-based ones January average is at 2.1% (5Y ILS) and at 1.9% (5Y5Y ILS). Generally, the inflation-linked swaps are close to or above 2% from the 1Y to 30Y bucket.

The liquidity premium in the ILS biases these inflation expectations somewhat to the upside. But given the upside risks to inflation it becomes clear that there is no need for the ECB to push inflation expectations further up. Instead, there is a **risk that they become de-anchored**.

Euro area inflation expectations

Market (implicit average inflation expectations from inflation swaps) versus Survey of Professional Forecasters (SPF), monthly data



Source: Datastream, GIAM calculations

Favourable financing conditions still needed

While there is mounting support for a further unwinding of the highly supportive monetary policy stance the **GC will want to keep financing conditions still favourable in order to not jeopardize the recovery**. The output gap will according to the latest EC forecast close only in 2023. The Omicron-wave is a significant downside risk to activity via its direct impact on the euro economies which might be amplified by prolonged pandemic-related bottlenecks from intermediate goods producing (especially Asian) economies. The risk of escalating geopolitical tensions comes on top. Moreover, **financing conditions are already tightening reflecting the forthcoming Fed action**. We look for four key rate hikes in 2022 and the start of quantitative tightening. This has contributed and will continue to contribute to a rise in the term premium, leading to a further upside pressures on euro area core government bond yields. Moreover, peripheral government bond spreads have already started to increase.

The ECB's Financing Conditions Dashboard

z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations with latest data on lending rate estimated

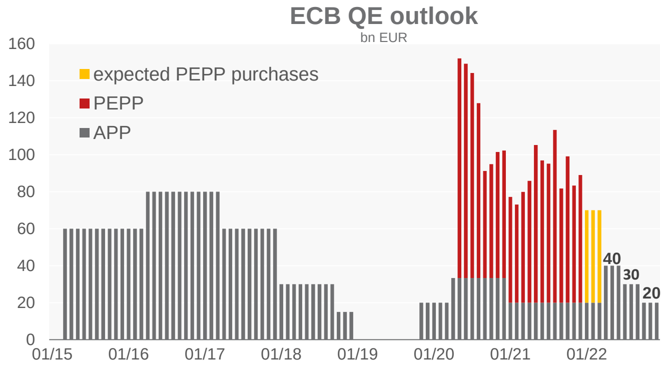
	2021	Q3 2021	Oct-21	Nov-21	Dec-21	Jan-22
Gov. bond spread (GDP weighted)	1.45	1.46	1.48	1.46	1.51	1.38
Term premium (10Y-1Y OIS)	1.01	1.14	0.63	0.79	0.82	0.38
BLS credit standards	-0.96	-0.21	-0.35	-0.49	#NV	#NV
BLS credit demand	-0.41	0.38	0.02	-0.31	#NV	#NV
High Yield spread	1.02	1.15	0.93	0.75	0.67	0.76
Lending rate	1.41	1.42	1.41	1.52	1.45	#NV
unweighted mean	**0.59**	**0.89**	**0.69**	**0.62**	**#NV**	**#NV**

last update: 26/01/2022

Source: Datastream, GIAM calculations

Step-by-step policy normalisation, 2023 first rate hike

We think that the **ECB will adopt to a step-by-step policy normalization course**. It announced at the December meeting to end the PEPP after March 2022. It will thereafter temporarily increase APP purchases to smooth the scaling down of overall QE support to € 20 bn per month in Q4. Annual QE will likely come down to € 440 bn in 2022, from € 1080 bn in the last year. Over the past year the GC stressed that the sequence for policy normalization is: (i) unwinding QE, (ii) hiking rates and finally (iii) selling (or not rolling over) purchased assets again (quantitative tightening). At the **end of 2022 QE will have sufficiently come down so that stopping it should not lead to major market gyrations**.



Source: Datastream, ECB, GIAM calculations

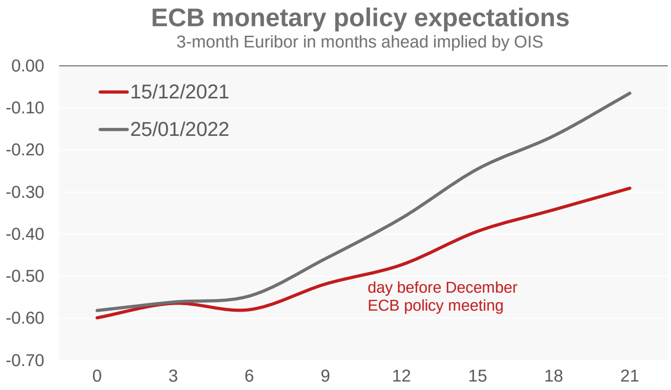
Given upside risks from energy prices, a likely stronger wage growth than currently pencilled-in by the GC and inflation expectations in line with target, we think that the ECB cannot afford to wait until 2024 and will need to act on rates in 2023 already. The hurdles for a rate hike under the new strategy are high: Both core and headline inflation need to be in line with the medium-term target well ahead before the end of the forecast horizon. But within the GC the awareness of heightened inflation risks seems to increase as the accounts for the December meeting reveal. Here, an increase in also underlying inflation was acknowledged, it was mentioned in the discussion that with the inclusion of owner-occupied housing costs inflation would have been higher and that there is a possibility of inflation being higher for longer. Moreover financial stability risks stemming from historically low rates could not be tackled by means of macroprudential measures only.

Over the course of the year the GC will likely need to adjust its projected inflation path (which will be done at the meetings in March, June, September and December) more and more to the upside so that the case for higher rates becomes stronger. In December 2022 the threshold for higher rates should be met. Moreover, the GC will also take into consideration that the latest stabilization of inflation expectations is largely due to the expectation of higher key rates. The ECB will have to deliver to avoid that inflation expectations rise further and become de-anchored.

All in all, we deem it now most likely that the **ECB announces an end of QE for January or March 2023 and embarks on a first deposit rate hike by 20 bps in June 2023**. The further policy moves will remain highly data dependent (especially on inflation) but we expect another hike in December 2023 (most likely by also 20 bps) which would leave the deposit rate still in negative territory (at -0.1%) but pave the way for an end of the negative interest rate policy persisting since 2014.

Market expectation of rate hike in 2022 only tail risk

Markets have a much more aggressive view of ECB rate hikes. Already last autumn they embraced the idea of a 2022 rate hike. Since then GC members have continuously communicated that this is overdone and President Lagarde among other called this "*very unlikely*". Notwithstanding these comments expectations of a 2022 rate hike even intensified after the December meeting. A reason might be that markets take the Fed as a blueprint. However, the situation there is very different. For instance, US hourly wage growth averaged 4.9% yoy in Q4/2021 as the labour market ran hot. The euro area is far away from such a situation and it is hard to image realistic circumstances under which the ECB would depart from the announced sequence of policy steps and hike while still conducting QE (as it may also entail an unwelcome flattering of the yield curve). Without lasting damage to credibility this would need an extraordinary event which we could imagine only as a tail risk. Accordingly, **we recommend marking profit of current market pricing by taking a long position in the 3-month Euribor December 2022**.



Source: Datastream, GIAM calculations

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