29 August 2022

New ECB call

We expect 75bp at the meeting next week

- In light of the numerous hawkish comments and sources stories during the weekend, we now change our ECB rate call.
- We now expect ECB to hike 75bp next week, which will be followed by 50bp in October and 25bp in December, but acknowledge the increased uncertainty on the two latter hike size expectations. This is +25bp for our previous rate hike expectations at both the September and the October meetings, respectively, and we now see the end-point of the ECB deposit rate at 1.5%.
- As regards the reinvestment schedule, we currently do not foresee that ECB will change it, but increased market and ECB focus in coming months will intensify discussions ahead of December, where such decisions could be taken.
- We believe the euro area will face a recession and ECB will hike into that, however, we also acknowledge that even without the ECB tightening, the European economy was in a severe situation to begin with a worsening energy crisis.

Intensifying inflation pressure - hawks are on the wires

The European economy is facing a large supply shock on the back of spiralling gas and electricity prices in the past couple of weeks. As a result, we have seen a significant intensification of the near-term inflation pressure, with the inflation peak now projected by markets above 10% in December (compared to an expected inflation around 9% in September for most of Q2). As a result of the intensifying inflation dynamics we have also seen increased volatility and uncertainty around this. This has lead the particularly hawkish members of the ECB's Governing Council to be very aggressive and argue for a sharp tightening need in the past couple of days. They also point to increased risks of inflation expectations becoming de-anchored or a wage / inflation spiral kicking in.

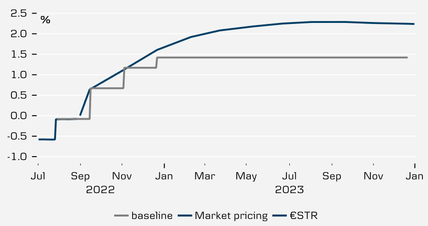
Important speech by Schnabel

During the Jackson Hole conference this weekend, the influential ECB member *Schnabel* outlined a very hawkish presentation, when she shared her view of the economy and inflation outlook. While Schnabel argued for a new era of volatility, with a less favourable environment where shocks are potentially larger, more frequent and persistent, she also recalled that the ECB has a price stability mandate, which may be controversial in an environment of elevated uncertainty and structural change in economic dynamics. However, she argues that in **certain circumstances stabilising inflation is no longer equivalent to stabilising output during shocks and therefore implies a trade-off for monetary policy, between inflation and output**. Furthermore, Schnabel said that central banks can take two paths: either 1) 'caution', in line with the view that monetary policy is the wrong medicine to deal with supply shocks or 2) 'determination' with a forceful response to inflation even at the risk of lower growth and higher unemployment. She points to three arguments of why central banks should act with determination now: 1) inflation uncertainty, 2) credibility and 3) the cost of acting too late. Further, she argued that in

Key takeaways

- We now expect ECB hikes of 75bp in Sep, 50bp in Oct and 25bp in Dec.
- ECB is ready to fight inflation at 'all costs', even at the risk of a deeper euro area recession and higher unemployment

New ECB profile for rate hikes



Source: Macrobond Financial, ECB, Danske Bank

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circumstances where the degree of inflation persistence is uncertain, it is '*largely irrelevant whether inflation is driven by supply or demand. If a central bank underestimates the persistence of inflation – as most of us have done over the past one-and-a-half years – and if it is slow to adapt its policies as a result, the costs may be substantial.*'

We were somewhat surprised with her speech and that she argued that the source of inflation was less relevant, as we question how tightening through higher rates will result in lower inflation, as the main source of inflation is coming from the food and energy component. However, the determination to price stability is very clear, as her remarks also reflect an acceptance that a recession with higher unemployment may be a result, but the risk of acting too late overshadows a more cautious approach.

More weight on realised data

As a result of the uncertainty about economic forecasting in the current environment, several Governing Council members have argued for putting more weight on realised data rather than projections. As the labour market remains solid and relatively tight by historical standards, growth is not yet collapsing and inflation remains on an upwards trend, we expect ECB to frontload its monetary tightening.

Sources stories and new call

During this weekend, we also had several sources stories out. On Friday, Reuters reported that a 75bp hike will be discussed at the September meeting. While we originally had anticipated that ECB would only hike 50bp next week, we expect the hawks have the upper hand and as Schnabel, Holzmann, Kazaks, Knot all seemingly are in favour of a 75bp move and Rehn and Villeroy mentioned a 'significant' rate move was to be expected in September, we judge that ECB will follow in the footsteps of the Fed and hike by 75bp at the September meeting.

ECB has in practice stepped away from giving any form of forward guidance, by taking a meeting by meeting approach to its decisions. That is understandable given the increased volatility and uncertain outlook. However, looking ahead and assuming that ECB's determination to fight inflation still applies, even as the European economy is heading into a recession, accompanied by higher unemployment, we anticipate ECB to hike by 50bp at the October meeting and 25bp at the December meeting. We acknowledge that the uncertainty is high on the latter two hikes. Looking into 2023 it is a very uncertain outlook and for now we stick with a cumulative 150bp rate hike, but more could come depending on how severe the European recession will look.

Markets price more in than we anticipate

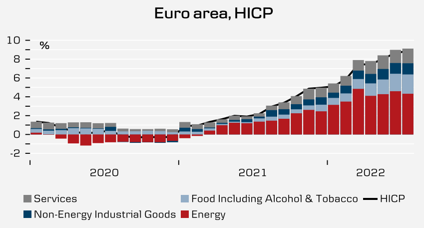
On the back of the hawkish signals during the weekend, markets have added some 30-40bp rate hike into its expectations for where the 'terminal rate' will be. Markets price that at 80bp higher than we anticipate right now.

As of the September meeting, markets currently price in 64bp, which equates to almost 60% probability of a 75bp rate hike by the ECB.

Liquidity tightening and reinvestment profiles

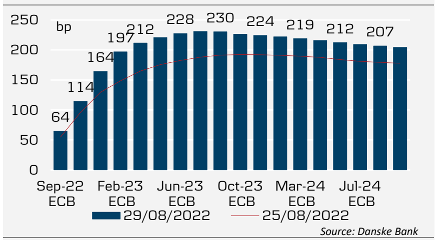
Sources during the weekend also mentioned the possibility of ECB looking in its reinvestment policies under the APP. We anticipate the topic to continue to float in financial markets in the coming months, but no decision until December at the earliest, and at that stage it will also depend on how severe a recession we are seeing in the euro area.

Drivers of euro area inflation



Source: Eurostat, Macrobond Financial, Danske Bank

ECB market pricing



Source. Danske Bank

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Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

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