How far is the ECB from the phantom neutral level?

For the European Central Bank, the question is no longer if but when and by how much it will hike interest rates this summer. Once the rate lift-off has started, the next question will be how far the ECB can go

The debate about neutral interest rates has gained momentum. More often now, ECB speakers cite this theoretical level in reference to how far rates will have to increase to fight inflation effectively. That makes it worthwhile to spend some time on getting a good sense of where the current sweet spot of neutral monetary policy could be. We argued in this piece last week that an invisible and moving target is hard to shoot for and that it is better for the ECB to continuously assess how the economy responds to higher rates to see how close it is to an economy that sees inflation revert to 2% in the medium-term. We still prefer the broader concept of financing conditions over any theoretical construction of a neutral interest rate (range).

In this piece, we will assess how the economy has responded so far to the reduction of net asset purchases and expectations of rate hikes to get a sense of how far the ECB is likely to increase its policy rate. At this point, we don't expect the ECB to hike as much as the market

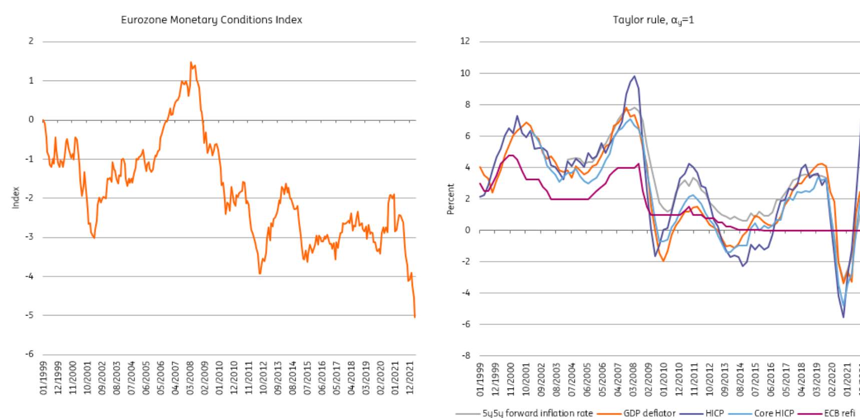
does as signs of slowing in the economy and tighter financial conditions suggest that neutral may be reached a lot sooner than many market participants think.

So how loose is policy at this point?

Monetary policy has been ultraloose in the eurozone for a long time and especially in recent months. As inflation has shot up, real interest rates have been plummeting. In combination with a weakening euro, this has resulted in the loosest environment since the start of the Monetary Conditions Index created by the European Commission – chart 1. Adjusted Taylor rates – although we're not big fans of these either - have also turned positive again and are approaching 2018/19 levels. All indicators from the monetary side confirm that it is indeed time to increase rates for the first time since 2011. And most would suggest that substantial rate increases are on the cards.

But the reality is not that simple. These rule-of-thumb indicators help to assess the stance of monetary policy from a historic perspective but are flawed as a basis for setting policy – just like neutral rates.

Monetary policy is ultra loose, suggesting it's time for lift off



Source: European Commission, Macrobond, Refinitiv, ING Research calculations

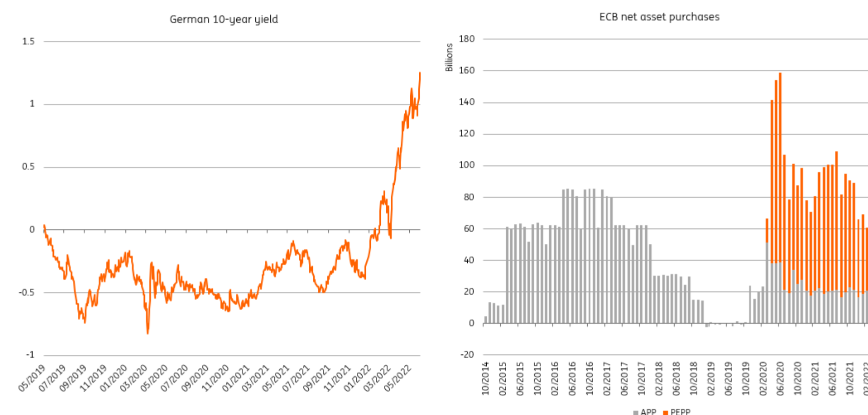
How is the economy responding to higher long-term interest rates?

Despite the picture of ultra-loose monetary policy that the above indicators paint, let's not forget that some tightening has already occurred recently. The ECB has ended net purchases under its Pandemic Emergency Purchase Programme and is about to do the same to the Asset Purchase Programme. This, among other drivers, has had an upward effect on long-term yields, which have been on the rise significantly. With higher long-term interest rates comes financial tightening. At this point, the increase in German 10-year yields has been more than 1.5ppt since December last year, which means that the economy is not just cooling because of the effects of the war, but that higher yields are having a tightening impact, too.

Looking at it more granularly, we see that the ECB's bank lending survey suggests that banks have tightened credit standards substantially this quarter. This means that it is becoming harder for businesses and households to borrow, not just from a cost perspective, but from the perspective of

eligibility as well. In April, businesses – mainly in the service sector – were already indicating that financial factors were starting to limit production again (albeit at relatively low levels). Credit spreads have also been on the rise, meaning that larger businesses that borrow in the market are paying more to borrow. Financial conditions have been tightening more quickly than monetary conditions so far, which means that the market is doing some of the heavy lifting for the ECB already.

Net asset purchases are ending and long-term yields have shot up in recent months



Source: Macrobond, ECB, ING Research

A cooling economy brings us closer to neutral as well

Still, it's hard to disentangle the effects of higher interest rates from other factors influencing growth. Uncertainty from the war, high inflation itself, and a cooling global economy are just a few factors impacting the consumption and investment channel at the moment.

With consumer confidence at recessionary levels – probably in response to war uncertainty and the record drop in real wages – it is likely that consumption will cool further in the months ahead. Industry is in a worse position still. With supply chain problems resurfacing and new orders weakening, the sector is set to underperform. Investment appetite has also been waning, according to the ECB. This means that the eurozone economy is set to flirt with recession in the coming quarters. Some ECB policymakers might be tempted to hike interest rates in a technical recession. However, we wonder whether there is really a majority at the ECB which favours rate hikes going significantly beyond the end of net asset purchases and negative deposit rates if the eurozone economy were to enter a recession.

Neutral may be closer than most of us seem to think

There is no doubt that the ECB must start hiking interest rates. Ending net asset purchases and negative deposit rates stands high on the agenda. However, let's not forget that inflation is still dominantly a supply-side issue and that the normalising of ECB policy will mainly affect the demand side of the economy. In other words, if the ECB really wants to bring down inflation, it has to weaken the entire demand side of a still weak eurozone economy, faced with high uncertainty and enormous structural changes. To us, this limits the scope for an ECB tightening cycle. Early signs of tightening at the long end of the curve suggest to us that neutral may be at the lower bound of what's currently being estimated, and the slowing economy may bring that down even

further. Consequently, we expect the ECB to hike by 100 basis points between July and 1Q 2023 before taking a pause to see what effect this has had so far. The largest chunk of these hikes will probably be done over the summer. The main risk to this call is that no single ECB decision-maker has any experience with normalising monetary policy. This is why policy mistakes - in an attempt to crush the potential de-anchoring of inflation expectations - cannot be excluded entirely.

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