

## How the ECB will spell out optionality this week

Looming stagflation in the eurozone has complicated the European Central Bank's life. Higher inflation for longer and a very uncertain outlook for growth not only in the short but also longer-term will worsen the ongoing controversy between ECB hawks and doves. We hope for somewhat more clarity on how the ECB sees its own options at next week's meeting



European Central Bank  
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The economic implications of the war in Ukraine are only slowly starting to show in official statistics and forward-looking indicators. While the eurozone might still have avoided a contraction of economic activity in the first quarter, the near term outlook is anything but rosy. Ongoing supply chain frictions in China, new supply chain frictions as a result of the war, trade disruptions, uncertainty, and above all high energy and commodity prices, will significantly weigh on economic activity in the coming months. The risk is high that not only consumption will suffer under high energy and commodity prices but also companies will have increasing problems dealing with rising costs. And this scenario is not even taking into consideration that additional sanctions could lead to serious energy supply disruptions. To use ECB language: the economic outlook for the eurozone has clearly worsened and risks are definitely tilted to the downside.

The latest inflation numbers will once again have made ECB staff cry. It is déjà-vu, with the same thing happening almost every month; headline inflation coming in higher than the ECB expected. With higher energy and commodity prices and the actual March headline inflation of 7.5%, the ECB's inflation forecast of 5.1% for this year is already outdated. We no longer exclude double-digit monthly inflation rates over the coming months. Risks to the inflation outlook are definitely tilted to the upside.

As naive as it might sound, the rise in headline inflation is to a large extent still mainly driven by energy and commodity prices and could therefore still be labelled as transitory or temporary. Only that this period of transition takes extremely long and will very likely lead to permanently high price levels, which in turn are harmful to consumption and economic activity in general.

## ECB facing looming stagflation

This described macro-economic backdrop with looming stagflation has complicated the ECB's life and probably also widened the rift between doves and hawks. While the doves are likely to focus on the worsening economic outlook and high uncertainty, arguing in favour of a very gradual, if any, normalisation of monetary policy, the hawks have been very vocal in calling for at least two rate hikes this year. For them, the risk is high that the ECB has fallen behind the curve. They probably also fear that the window for monetary policy normalisation is closing very quickly in case the eurozone continues flirting with recession, the US economy would slow down at the turn of the year and the Federal Reserve would make a full U-turn on its current tightening cycle.

## Distinction between normalisation and tightening

Up to now, the ECB has officially always stressed the optionality and data dependence of its next decisions. Nothing is wrong with this but if there are too many options on the table, observers and financial market participants can get confused. And this is exactly what, at least in our view, the latest market pricing of four ECB rate hikes this year is showing. Therefore, it would be good for the ECB to add somewhat more colour to its optionality or even limit the optionality to only a few options at next week's meeting.

A possible way forward, which would also bridge the rift between doves and hawks and would enable the ECB to tread very carefully in these times of high uncertainty, would be an even more explicit distinction between policy normalisation and monetary policy tightening. Normalisation would include an end to net asset purchases and bringing the deposit rate back to zero. Tightening would be the start of a longer rate hike cycle, bringing rates close to, or even above, neutral levels (wherever these levels might be). Normalisation seems to be acceptable for both hawks and doves – there are only different views regarding the timing. Tightening is definitely not yet an option for the doves, and even not for all hawks.

## Looking beyond normalisation

We still think that the ECB will have ended its net asset purchase programme in the third quarter and will return the deposit rate back to zero at the latest around the turn of the year. With the current inflation outlook, there is a risk that this return to zero could happen slightly earlier but more on this later. Once the deposit rate is back at zero, the longer-term inflation forecasts will be of even higher importance for any next step. Unless energy prices continue to accelerate, there will be negative base effects on headline inflation in the course of 2023, bringing headline inflation closer to 2% again. For the ECB, the main indicators to watch are and will be wage developments

and inflation expectations. As long as wage growth remains below 3%, an outright ECB tightening cycle is unlikely. Add to this a further acceleration of government debt, driven by fiscal spending on defence and the green transition, and an outright tightening cycle becomes even more unlikely. The more general discussion the ECB will have to have at some point in time is how to react to structurally higher, but externally driven, inflation due to the first years of the green transition. We expect the ECB to only very cautiously engage in outright tightening once the so-called unconventional measures have been returned into the toolbox.

## Three possible ECB scenarios going forward

Obviously, the future path for the ECB is highly conditional on how the war will develop and how its implications on uncertainty, energy and commodity prices will evolve. The earlier any kind of macro stabilisation kicks in, the earlier the ECB could start hiking rates; and vice versa. Assuming that there won't be a quick return to a new normality, we see three possible scenarios for the ECB:

1. Our base case: The ECB continues with reducing net asset purchases, ends them in the second quarter of 2022 and starts hiking interest rates by 25bp in quarter four and another 25bp in the first quarter of 2023. In this scenario, forecasts point to a drop in headline inflation to around 2% over the medium term and the sheer fact that the ECB is committed to gradual normalisation bridges the rift between doves and hawks. A new asset purchase programme will be announced to tackle any unwarranted widening of spreads across eurozone countries.
2. Earlier and more aggressive normalisation: Higher inflation for longer but still moderate longer-term inflation expectations scare the ECB so much that it sticks to its plan to end net purchases in the second quarter of this year but hikes interest rates by 50bp in September.
3. The fear move: Inflation expectations start to rise and a majority at the ECB fear falling desperately behind the curve. As result, the ECB gives up on the principle of sequencing, ie first ending net asset purchases before hiking rates, and raises interest rates by 50bp in June or July, while extending net asset purchases at a very low level throughout the year.

## What to expect from the ECB next week

Next week's meeting is not a meeting for actual policy action. There simply is too little hard data on the macro-economic implications of the war in Ukraine yet. And there simply is too much uncertainty about how the war will evolve. Staying put and continuing with the announced reduction of net asset purchases looks like the only viable option for now. However, given the latest market pricing of future ECB rate hikes and unclarity about the ECB's exact reaction function in these times of high uncertainty, ECB President Christine Lagarde could be forced to somewhat limit the ECB's optionality to a few options.

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