March staff projections will be another argument for ECB hawks

The European Central Bank staff is currently working hard on the March macro projections. As the cut-off date for the technical assumptions has been reached, we take a look at how these assumptions alone will give the hawks enough support to get the ECB to announce the end of QE at the March meeting

European Central Bank, Frankfurt, Germany

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“It’s difficult to make predictions, especially about the future”. Every professional forecaster knows this humorous saying and it nicely illustrates the difficulty every forecaster is facing. Everyone knows how uncertain forecasts are, but still there has always been high demand for predictions of all kinds. Be it about the weather, sport games, financial markets or the economy. For ECB staff members, the demand for their next round of economic forecasts has never been higher. The heat is almost unbearably on for ECB staff as the outcome of the forecasts will have direct policy implications.

The ECB excitement continues. Last week, ECB President Christine Lagarde tried to return the hawkish genie back into the bottle and Chief Economist Philip Lane felt urged to publish another blog entry on the ECB site, explaining the inflation differences between the US and the eurozone. This was not an attempt to fully reverse the main messages of the ECB press conference. Don't forget that the new hawkishness with 'risks to the inflation outlook are tilted to the upside' and the disappearance of the phrase that 'monetary accommodation was still needed for inflation to stabilise at the 2% inflation target' was agreed and prepared by the entire ECB Governing Council. However, the ECB had clearly not expected such an aggressive reaction by financial markets, pricing in two rate hikes already this year. We expect more calming interventions by ECB officials in the coming weeks, without taking away the hawkish twist.

What to expect from the ECB's March inflation projections

The next ECB showdown will be the 10 March meeting. This will be the moment to alter its asset purchase programme and this will also be the moment to possibly give clearer guidance on future rate changes. All these decisions will be closely linked to the ECB's staff projections.

A lot of pressure has been on these staff projections as they have structurally underestimated recent inflation dynamics, as much as they structurally overestimated inflation dynamics in the decade before the pandemic. Though formally correct, it is remarkable that several ECB officials recently commented that the staff projections were not the Governing Council's forecasts and that the Governing Council was not bound by these forecasts. Let's not forget that these so-called staff projections twice a year are the result of joint forecasts by the national central banks and twice by ECB staff in Frankfurt. Enough to have sufficient buy-in also from national central bank governors one would think.

In any case, the March projections will be ECB staff projections and if the past is of any guidance, the cut-off date for these projections must have been any of the last days. As any inflation projection is currently highly dependent on the underlying energy price assumption, we have a brief look at the technical assumptions the ECB uses and how they have changed since the December meeting.

The ECB uses so-called technical assumptions for the euro exchange rate, oil prices and interest rates. For the exchange rate, this assumption is simply a continuation of the values of the last two weeks before the cut-off date, for interest rates and oil prices, the ECB uses future prices.

- **Bond yields.** The hawkish tone at the ECB press conference pushed up bond yields and widened spreads by some 50 basis points compared with the December projections. At first glance, the irony is that the strong reaction by financial markets could actually undermine any ECB normalisation plans. However, at second glance, changes in bond yields with these magnitudes have hardly had any impact on its inflation forecasts
- **Exchange rate.** Compared with the December projections, the change in the euro exchange rate has been too small to have a direct impact on the ECB's inflation forecasts.
- **Oil prices.** Again the main driver of the ECB's inflation forecasts. Compared with the futures applied in the December projections, oil price futures were up by another 10% across the curve. This alone could push up headline inflation by 0.1 to 0.2 percentage points.

Back in December, the ECB projections predicted headline inflation to come in at 3.2% in 2022 and 1.8% in both 2023 and 2024. Simply applying what we expect the next technical assumptions to be should push the inflation projections for 2023 and 2024 already very close if not exactly to 2%. And there will be more: the pass-through of higher energy and commodity prices has been structurally underestimated by the ECB's macro model and could be remodelled based on the experiences of the last months, opening the door for further upward revisions of the inflation forecasts.

Given the rising criticism on the ECB forecasts voiced by several ECB officials, we expect a growing majority at the ECB to at least support a faster reduction of the asset purchases at the March meeting. For this, inflation doesn't have to be at 2.0% over the next years. Interestingly, if oil prices were to stay at their current level, headline inflation would have to be revised up by some 0.5 percentage points for 2023 and 2024. This is something that will also not have escaped the attention of ECB members.

> It is hard to see how the March ECB inflation forecasts will not be higher than in December. Admittedly, it is still mainly an energy price story but another upward revision of the 2023 and 2024 forecasts will convince enough ECB members to support a faster reduction of the asset purchases and to bring them to an end by 3Q, opening the door to a rate hike in 4Q.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

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