3 March 2022

ECB Preview

Inflation forces the normalisation process to continue

- A difficult ECB meeting is due to take place on Thursday next week. After the pivotal hawkish communication shift at the February meeting, the ECB will have to balance a stronger inflation outlook with the highly uncertain economic impact of the Ukraine-Russia war.
- We expect the ECB to continue its path towards entering a 'neutral' monetary policy calibration and formally set an end date for the APP programme (in September this year), due to the high inflation pressure, but fall short of giving a firm indication of an upcoming rate hike. We expect the ECB to remove the 'or lower' wording from the forward rates guidance and give no time indication between the end of APP and the first rate hike, by removing 'shortly before' from its decision statement.
- The staff projections are likely to contain exceptional uncertainties given the implications of the Ukraine-Russia war are not yet known. We expect the staff projections will point to 2% core inflation in 2023 and 2024, allowing the policy normalisation process to continue.
- We acknowledge there is a risk of our expected 'continuation of normalisation' process view only coming at a later stage, as it may be a politically difficult decision to tighten monetary policy with a war on the continent. However, we expect the high underlying inflation pressure to prevail in the discussion (especially after February's core inflation of 2.7% y/y, 0.4% m/m sa), despite the weaker growth outlook.
- The ECB is attentive to financial stability and may launch a 1y LTRO operation already in March 2022. We expect a formal end to the TLTRO discount to be set for June 2022, as widely expected.
- We think markets may be in for a hawkish surprise initially, but for now we find the 27bp priced for a December hike this year as fair from a risk/reward perspective.

Resilient economic backdrop with uncertainty due to war...

Russia's aggression in Ukraine is an unpleasant source of uncertainty for a central bank and particularly after the ECB's hawkish pivot at the February meeting, clearly raising expectations for policy tightening ahead. The stronger-than-expected economic backdrop and tight labour markets with high and more persistent inflation pressures should – all else being equal - make the ECB fairly confident that a gradual and flexible approach to monetary policy normalisation is needed. However, stressing a highly data-dependent stance with optionality will remain crucial in our view.

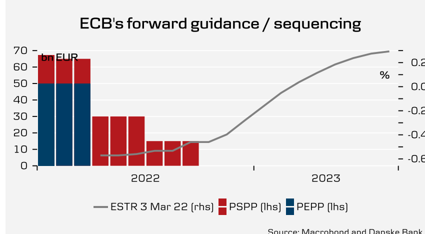
...but high inflation to keep pressure on ECB to start policy exit

It will be a difficult communication exercise awaiting the ECB at the March meeting. The economy rebounded at the turn of the year as fading Omicron headwinds and easing supply chain stress underpinned services and manufacturing activity. The labour market recovery also continued at a rapid pace, with the unemployment rate falling to a new all-time low of 6.8% in January and labour force participation standing above pre-crisis levels.

10 March 2022

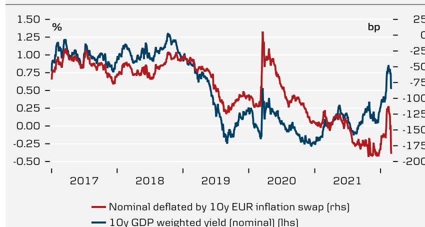
- 13:45 ECB decision
- 14:30 Press conference

ECB expected to revise QE bond buying



Source: Bloomberg, ECB , Danske Bank

Real rates return to record low



Note: Past performance is not a reliable indicator of current or future results

Source: Bloomberg, Macrobond, Danske Bank

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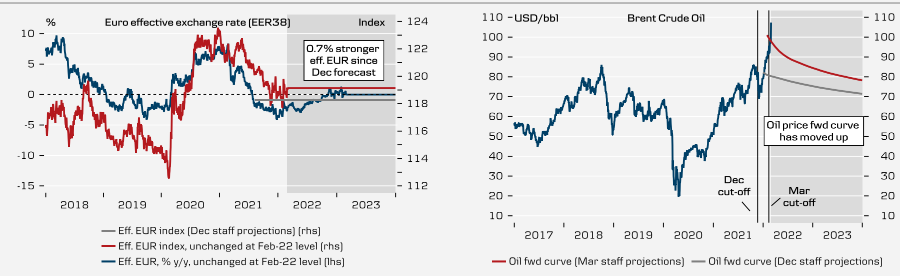
However, since **the Ukraine crisis has clouded the near-term economic outlook again and we see downside risks to our euro area GDP forecast of 0.4-0.5pp in 2022, mainly from the adverse hit to consumers from continued high inflation** (read more in *Research Euro Area - Rising stagflationary headwinds from Ukraine conflict*, 28 February).

However, the stagflationary forces (i.e. weaker growth and higher inflation) from the Ukraine-Russia war put the ECB in a tricky position in how to react in terms of policy calibration. **Inflation pressures continue to build at an unrelenting pace, as cost-push inflation is working its way through the pricing chain** (see also *Euro inflation notes - Cost-push inflation: the genie is out of the bottle*, 23 February). Both HICP and core inflation rose to new record highs of 5.8% and 2.7%, respectively, in February, strengthening the hawks' case for an accelerated tightening pace. Markets are pricing the coming seven HICP inflation prints in excess of 6%. We expect the ECB's new staff projections to feature a weaker near-term growth outlook, but marked upward revisions on the inflation dynamics, given repeated inflation upside surprises and higher commodity prices feeding into the forecast.

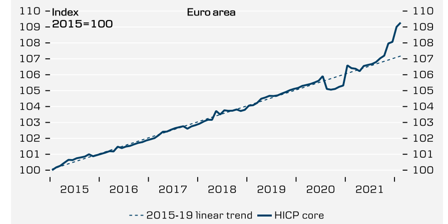
Even with German VAT effects out of the equation, core inflation pressures are broadening and inflation rates well above target throughout the year raise the risk of wage adjustments down the line. Hence, **we now also expect the 2023 and 2024 forecasts to project inflation at target, allowing for a gradual policy normalisation,** as all three inflation conditions (at target, durable and broad-based) are met. That said, given the heightened uncertainty about the economic outlook, we expect the ECB to refrain from tying its hands too much, especially with regards to its forward guidance on rate hikes.

Technical assumptions support upward revisions in inflation forecasts



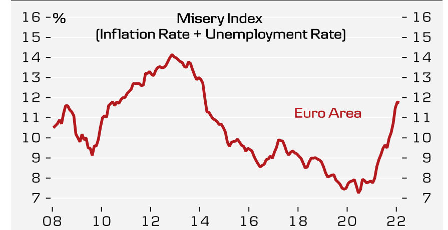
Source: ECB, Macrobond Financial, Danske Bank

Inflation pressure continues to build at an unrelenting pace...



Source: Eurostat, Macrobond Financial, Danske Bank

...and consumers are feeling the pinch



Sources: Bloomberg, Danske Bank

Inflation back to target in 2023 and 2024

ECB projections March 2022	2022		2023		2024	
GDP growth	3.6% (4.2%)	↘	3.1% (2.9%)	↗	1.6% (1.6%)	→
HICP inflation	5.0% (3.2%)	↗	1.9% (1.8%)	↗	2.0% (1.8%)	↗
Core inflation	2.6% (1.9%)	↗	2.0% (1.7%)	↗	2.0% (1.8%)	↗

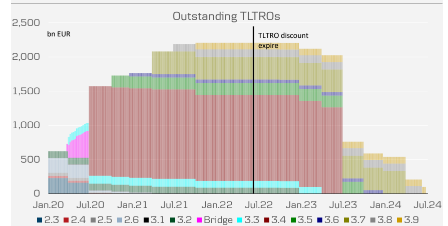
Parenthesis are the old ECB projections (from December 2021)

Source: ECB, Danske Bank

Policy calibration - announce end of APP and 'delay' hike

The ECB may find it politically challenging to announce an end to the APP programme as long as the full ramifications of the war are not known. However, as euro area inflation is running at high levels, **we believe the ECB will announce an end to the APP at the upcoming meeting, with the last purchase taking place in September 2022**. We believe ECB president Lagarde will stress that the ECB will still ease monetary policy in the coming months via its bond purchases, and could also recalibrate the APP to be conducted for longer if needed. Judging from markets (real rates hovering around record low levels), the ECB is still conducting historically easy monetary policy. The exact purchase volume for Q2 and Q3 this year is difficult to assess, but we expect the ECB on average to purchase

Maturity profile of TLTRO operations



Source: ECB, Danske Bank

EUR40bn/month in Q2 and EUR20bn/month in Q3. We do not see continued bond buying when financial fragmentation and financial risks are limited (e.g tighter BTPs-Bund spreads) on the back of the Ukraine-Russia war, and as inflation persistently above target puts into question whether additional QE will carry more pros than cons at this juncture.

On policy rate guidance, **we expect the ECB to remove the 'or lower' from its current 'at present or lower' rate policy guidance and remove the 'shortly' from the 'shortly before' reference between ending QE and hiking rates**. We expect Lagarde to firmly stress that sequencing will hold (no rate hike before end of QE).

While the above is part of a normalisation process, the ECB's attention to financial stability, and in particular to European banks with exposure to Russia, may see the launch a 1y LTRO operation to be conducted at the average deposit rate of the life of the operation with quarterly repayment possibilities. This should address the risk of a potential fallout in certain banking systems.

Central bank comments

This week, Stournaras and Rehn have argued for a more cautious approach to the policy calibration in light of the Russian aggression. Stournaras even argued for a continuation of bond buying through the end of this year. At the same time, the relatively more hawkish camp with Schnabel has argued that the persistence in inflation (also noting the owner-occupied housing discussion, which would have added 0.6pp to core inflation in Q3 last year if included) will continue to add to pressure and hence normalisation was necessary. Front-end market pricing, which now points to a 27bp hike in December, is in line with Knot's view of a hike at the end of the year. Knot has traditionally had hawkish credentials. The ECB accounts, which pre-dated the Ukraine-Russia war, carried a number of hawkish sections, including an acknowledgement that the probability of inflation had shifted, while doubts were also expressed whether inflation would be below 2% in 2023. Finally, '*Net asset purchases and negative policy rates were no longer seen as consistent with the incoming data*'.

Market implications – risk of a hawkish market reaction

It is always a challenge to forecast the intraday reaction to a central bank meeting a week in advance. However, in rates markets we expect the policy calibration to be a hawkish surprise as consensus seems to be focusing on a wait-and-see decision, thereby allowing bond purchases to continue. However, with bond buying set to end in any case due to the high inflation pressure, markets are likely to be disappointed in any case. Only in case of a firm commitment from the ECB to extend bond buying beyond the end of this year do we expect to see a dovish surprise. Looking further ahead with high inflation and slowing growth, we expect the long end to perform and look for flatter curves.

Commodities are key for EUR/USD

With the likely formal announcement of an end to the ECB QE programme and a concerned but upbeat outlook from Lagarde, we could see some upside to EUR/USD on the day of the ECB meeting. However, looking a bit further ahead, we believe the **key theme in spot EUR/USD is not interest rates but more the rise in global commodities**. As such, with the very long runway before we start to see an actual hike from the ECB, we expect energy prices to be the key driver in spot FX in the near term. The Russian war in Ukraine affects spot via two key channels: firstly, rising risk aversion weighs on all European assets and, secondly, rising commodity prices are a negative terms-of-trade shock to Europe. We continue to forecast 1.08 and a further escalation of the war will likely be negative for spot.

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Piet Haines Christiansen, Chief Strategist, ECB and Fixed Income Research, Aila Mihr, Senior Analyst, and Lars Sparresø Merklin, Senior Analyst.

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Ad hoc.

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