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ECB rate hikes: how could they start?

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Despite guidance for a 'gentle' start to rate hikes, could economic conditions convince the European Central Bank to tighten monetary policy more aggressively?

In his most recent article 'The end of the Fed put', Kevin Zhao discussed the structural changes that central banks are now facing in this post COVID-19 environment. In this article, the parallels and differences between the hyperinflation of the 1970s and the rising inflation of today were discussed. It concluded that whilst the similarities are for all to be seen, central banks have, over the decades, put in clear monetary frameworks to deal with inflation shocks. But one central bank that did not exist in the 1970s is the European Central Bank (ECB). Given the current inflationary environment in the European Union (Chart 1), could the ECB be in a position to raise rates at their July meeting by 50 bps?

ECB President Lagarde guided expectations at the June meeting for a 25 bps hike, their first change since 2019, but more importantly, their first increase since 2011. "A gentle start" is how she and her close colleagues from the governing board described it. However, she also used the word 'flexibility' twelve times, adding that the Council was prepared to use the flexibility given by their mandate on inflation[1]. This has been interpreted as a dovish inclination initially, but recent developments would actually give them the opportunity to tighten more. Here is why.

[1] Source: ECB, transcript of June 9th press conference. "Throughout this process, the Governing Council will maintain optionality, data-dependence, gradualism and flexibility in the conduct of monetary policy."

Let us first look at fiscal policy in the run up to the external shocks. There are similarities. European governments have implemented furlough schemes and other measures involving monetary payments in exchange for job protection. The measures have given consumers the opportunity and the means to purchase goods that the global economy was not able to supply. The seeds of an inflationary shock had hence also been sown in Europe, albeit maybe to a lesser extent than in the United States.

Unsurprisingly, just like elsewhere in the global economy, inflation has hence started to rise in Europe as well, before the commodity shock drastically accelerated the rise in consumer prices. Compounding the issue since the invasion of the Ukraine by Russia, European politicians have taken drastic measures to abruptly reduce their dependency on Russian oil and gas. While the former is easy to replace, Germany's dependency (and other EU members) on Russian gas from the Nord Stream 1 pipeline is such that gas prices have risen by multiples of 100% since early March. This should continue to push headline inflation higher in Europe, well into the second half of this year.

Furthermore, there is more fiscal spending looming in the form of the European Reform and Recovery Fund. This is widely expected to start being disbursed in 2023 and hence support the European economy through investment. The ECB is well aware of this looming fiscal support, that it sees as a key positive going into 2023. This is the main tailwind that the ECB have been looking at to help the economy potentially come through a complete halt to the Russian supply of gas to Europe after this month's maintenance work on the Nord Stream 1 pipeline.

Let us now look to the monetary side of the equation. The experience of the 1970s showed that the central banks of the time might have not been in a position to tackle the rising inflation threat. The ECB has probably been the most prominent voice in the 'transitory' camp even though this is one of the few central banks whose mandate does not explicitly encompass a stable-to-growing job market objective. On this front and unbeknownst to (or maybe just ignored by) many market participants, just like Anglo-Saxon economies, unemployment has continued to fall sharply in Europe as well, reaching levels not seen since records started for this series – 1998 (Chart 2). The ECB are well aware of this development though and have been highlighting this positive over recent weeks.

The current weakness of the common currency, the euro (EUR), has been another factor that has been driving inflation higher (Chart 3). Europe imports oil and gas, commodities that are priced in US dollars. Recently, the velocity at which the EUR has weakened has attracted some ECB board members' attention. Many reasons can explain this weakness, but for the ECB, interest rate differentials have been going against the EUR recently and have contributed to its weakness. Delivering a strong first hike would help the EUR strengthen, just like the Swiss franc (CHF) did after the Swiss National Bank (SNB) unexpectedly hiked rates by 50 bps earlier this year.

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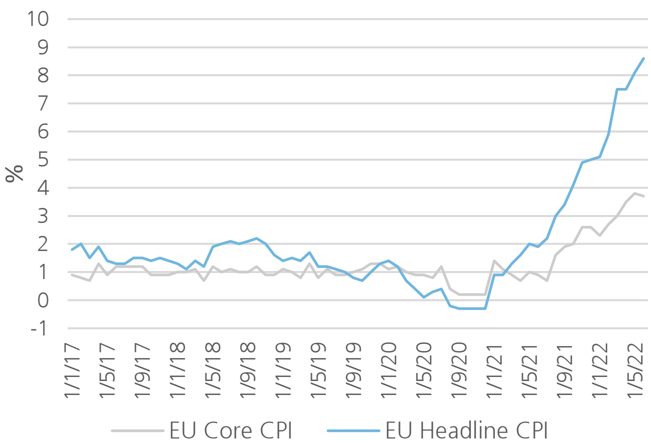
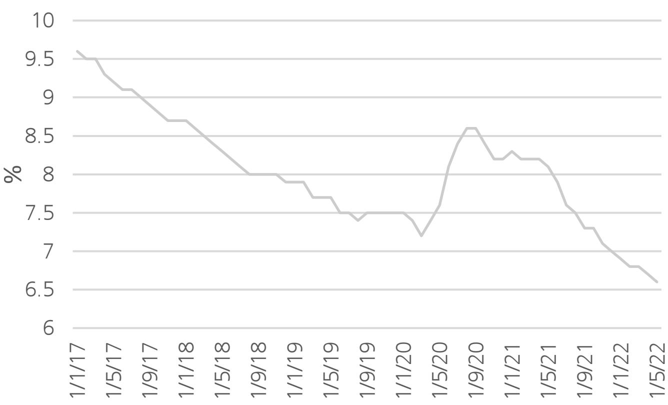
Chart 1: EU inflation rising steeply



Source: UBS AM, Bloomberg, as at 30 June 2022

Chart 2: Falling EU unemployment



Source: UBS AM, Bloomberg, as at 31 May 2022

The ECB have also expressed their worry about bond market spreads against Germany widening to levels that would cause unwanted effects on their monetary policy in some parts of the economy (Chart 4). A new tool has hence been announced, to deal with this fragmentation risk through the support of bond spreads. This tool is still in its infancy but could represent a way for the more hawkish side of the ECB board to negotiate a 50 bps initial hike in exchange for the creation of a tool that would skew support to some assets/markets over others. It is worth noting that since its announcement it has helped Italian bond spreads stabilize, playing into the hands of the more hawkish ECB governors.

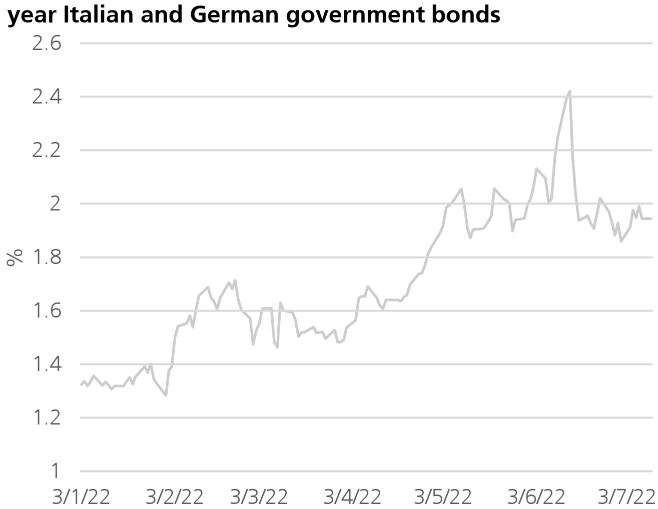
Lastly, the political landscape in Europe is likely to be supportive of the ECB taking action to tackle the rising inflation. This is a major difference to the US under the Lindon Johnson administration in the late 1960s. This combination of loose fiscal policy supported by loose monetary policy has been identified by economic historians as the reason why inflation had already started rising in the US pre the oil shocks of the 1970s. In today's Europe, politicians have been under pressure to tackle inflation. Measures have been taken in some countries to cap energy prices, but these measures are temporary by nature. A strong signal from the ECB (such as a more rapid path to 0%, hence starting with 50 bps rate hike) would probably be welcome in most of Europe's capitals.

To conclude, the ECB could well be in a position to deliver a first 50 bps hike on 21 July. Markets are not priced for such an outcome, even though the factors described earlier could inch the board to favor a surprise 50 bps hike.

Chart 3: Euro weakness against the US dollar

Source: UBS AM, Bloomberg, as at 30 June 2022

Chart 4: The widening spread between 10-year Italian and German government bonds



Source: UBS AM, Bloomberg, as at 11 July 2022

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