PREVIEW: ECB Policy Announcement due Thursday 9th June 2022

- **ECB policy announcement due Thursday 9th June; rate decision at 12:45BST/07:45EDT, press conference from 13:30BST/08:30EDT**
- **Policymakers are set to announce that purchases under APP will end as of July 1st**
- **The Governing Council will likely confirm that rate hikes will commence at the July meeting**

OVERVIEW: Since its previous meeting, Eurozone inflation has continued to pick up, with the headline rising from 5.9% Y/Y to 7.4% Y/Y in April, and then extending to 8.1% in May. This has struck a sense of alarm at the central bank, which has resulted in an increasingly hawkish tone from members of the Governing Council. A blog post in May penned by President Lagarde deviated from her usually non-committal stance; she now expects "net purchases under the APP to end very early in the third quarter. This would allow us a rate lift-off at our meeting in July". Furthermore, she added that "we are likely to be in a position to exit negative interest rates by the end of the third quarter", going on to state that "even when supply shocks fade, the disinflationary dynamics of the past decade are unlikely to return". This was viewed as giving the green light for purchases under APP to cease as of July 1st, paving the way for rate hikes at the July and September meetings, analysts said. Note, despite the pressing need to move on rates, the current sequencing between asset purchases and rate hikes means that a hike to the deposit rate will not take place at the June confab. For some of the more hawkish voices on the GC, such as Austria's Holzmann, the recent inflation metrics emphasise the need for a 50bps hike. However, this is an issue that is unlikely to be resolved at the upcoming meeting given that the discussion around the magnitude of a hike will likely be a feature of the July gathering. In terms of market pricing, at the time of writing, the market looks for around 132bps of tightening this year, which would imply 25bps hikes at the three of the four meetings after June, with one meeting expected to see a 50bps increase. Given the need for flexibility and lack of certainty surrounding the Eurozone outlook, it is hard to see how much vindication market participants will get for the aforementioned rate path. We will also be presented with the latest batch of macro projections from the Bank which will inevitably see an upgrade to the current 5.1% forecast for 2022 inflation. Of potentially greater interest will be the more medium-term forecasts and how they align with the Bank's 2% target. Finally, reporting over the weekend has suggested that policymakers could opt to strengthen the wording in its statement to underscore its commitment to avoiding fragmentation within the Eurozone.

PRIOR MEETING: As expected, the ECB refrained from tweaking its monetary policy settings with rates left unchanged and the parameters of its bond-buying operations maintained. As such, the ECB stated it will lower purchases under APP to EUR 30bln from EUR 40bln in May and then to EUR 20bln in June before concluding in Q3. At the accompanying press conference, introductory remarks from Lagarde stated that several factors point to low growth ahead, new pandemic measures in Asia are contributing to supply chain issues and inflation pressures have intensified across many sectors. On policy measures, Lagarde refrained from providing any firmer pointers on when in Q3 purchases under APP will conclude. Lagarde also reiterated her line from the previous press conference that the "some time" linkage between the end of APP and start of rate hikes could mean "weeks" or "several months". In the wake of the meeting, Reuters ECB sources suggested that policymakers saw a July hike as still possible, but they were unanimous in their support for April's decision. Meanwhile, Bloomberg sources suggested there was a growing consensus for a 25bp rate hike in Q3. Finally, during her remarks, Lagarde didn't add anything to the reports ahead of the meeting which suggested that the Bank was looking at crafting a crisis tool if bond yields were to jump.

RECENT DATA: Since the prior meeting, inflation has continued to pick up with headline Eurozone Y/Y CPI rising from 5.9% to 7.4% in April and then extending to 8.1% as rising energy and food prices continue to drive price pressures higher. The core reading (ex-food and energy) also remains at elevated levels, rising to 4.4% in May from 3.9% as input prices are passed on to consumers. Elsewhere, attention has also been placed on Q1 wage data which rose from 1.5% Y/Y to 2.8% Y/Y. As a reminder and as highlighted by ING, chief economist Lane had mentioned that wage growth at 3% is consistent with reaching the goal of 2% inflation in the medium term. On the growth front, Q1 Q/Q GDP growth was confirmed at 5.0%. Timelier PMI metrics saw the Eurozone composite PMI metric slip to 54.8 from 55.8 with the report noting that "Strong demand for services helped sustain a robust pace of economic growth in May, suggesting the eurozone is expanding an underlying rate equivalent to GDP growth of just over 0.5%. However, risks appear to be skewed to the downside for the coming months." Finally, unemployment in the Eurozone has continued to drift lower, with the April unemployment rate at 6.8%.

RECENT COMMUNICATIONS: Arguably, the most important intervention from the Bank came from President Lagarde with her now infamous May 23rd blog post in which she deviated from her usually non-committal stance to state that she expects "net purchases under the APP to end very early in the third quarter. This would allow us a rate lift-off at our meeting in July". Furthermore, "we are likely to be in a position to exit negative interest rates by the end of the third quarter". Lagarde also went on to state "even when supply shocks fade, the disinflationary dynamics of the past decade are unlikely to return". Chief Economist Lane (May 30th, pre-inflation) attempted to temper some of the more hawkish views on the GC by stating that monetary policy normalisation will be "slow" and the natural thing would be for 25bps increments. At the dovish end of the spectrum, the likes of Italy's Panetta (May 25th) has acknowledged that negative rates are "no longer needed today", however, he wishes to avoid a "normalisation tantrum", adding that "normal does not mean neutral". From a hawkish perspective, Austria's Holzmann (1st June, post-inflation) says the "record Eurozone inflation print backs the need for a 50bps hike". France's Villeroy has been relatively vocal since the prior meeting, noting that too weak a EUR "would go against the ECB inflation target". He also noted that he judges the neutral level of interest rates to be in the range of 1-2%.

RATES/TIERING/TLTRO: The ECB is expected to stand pat on rates with the deposit, main refi and marginal lending rates to be held at -0.5%, 0.0% and 0.25% respectively with policymakers likely to refrain from moving on rates at the upcoming meeting and therefore preserve their sequencing commitments which state that rate hikes will not take place until asset purchases cease (expected early Q3). In terms of signalling how the Bank intends to tighten policy in the coming months, it remains to be seen if the statement will stay as is for now or be modified to align with Lagarde's blog post which noted "we are likely to be in a position to exit negative interest rates by the end of the third quarter". Regardless, Lagarde will likely state that rate hikes are forthcoming at the accompanying press conference. For some of the more hawkish voices on the GC, such as Austria’s Holzmann, the recent inflation metrics back the need for a 50bps hike. However, this is an issue that is unlikely to be resolved at the upcoming meeting given that the discussion around the magnitude of a hike will likely be a feature of the July gathering. As it stands, market pricing looks for around 132bps of tightening this year, which would imply 25bps hikes at the three of the four meetings after June, with one meeting expected to see a 50bps increase. Elsewhere, analysts at Rabobank expect the ECB to confirm that the TLTRO-III discount will not be extended after June.

BALANCE SHEET: Current forward guidance notes that "net asset purchases under the APP should be concluded in the third quarter". Since the prior meeting, guidance has been clear that this will be "early Q3" and as such, consensus is firmly in favour of purchases ending on July 1st. Policymakers will continue to note that reinvestments from PEPP and APP will continue to support favourable liquidity conditions in the Eurozone. That said, there have been some concerns that the levels of reinvestments might not be enough to prevent fragmentation in the Eurozone as the ECB begins to normalise policy. Accordingly, there have been reports suggesting that the ECB could formulate a "new tool" to address this issue. A recent report in the FT has suggested that policymakers are expected to "strengthen their commitment to prop up vulnerable eurozone countries’ debt markets if they are hit by a sell-off". As it stands, it doesn't appear that the specifics of such a tool have been designed and therefore, for now, policymakers will likely enhance some of the language surrounding future bond purchases. One option, as suggested by the FT would be for the statement to incorporate similar language to that of Lagarde's recent blog post which reads "If necessary, we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalisation, as we have shown on many occasions in the past."

ECONOMIC FORECASTS: From an inflationary perspective, clearly inflation has surprised to the upside since the previous projection round in March. Accordingly, analysts at Nordea expect the 2022 forecast of 5.1% to be revised higher to around 7%. Nordea suggests that this will most likely understate the inflationary outlook given that the cut-off date for submitting the projections will likely not account for recent price movements, including the May HICP release. Of potentially greater interest will be the medium-term outlook and how it aligns with the Bank's 2% inflation target. As it stands, inflation next year is expected to pull back to 2.1%. A figure materially above 2% could be viewed as a green-light for the current path of market expectations which looks for 132bps of tightening by year-end. From a growth perspective, given the fallout from higher prices, Nordea expect 2022 and 2023 GDP projections to be cut to around 3.0% and 1.5% respectively from 3.7% and 2.8% respectively.

Current forecasts (from March)

GDP: 2022 seen at 3.7% (prev. 4.2%), 2023 seen at 2.8% (prev. 2.9%), 2024 seen at 1.6% (prev. 1.6%)

Inflation: 2022 seen at 5.1% (prev. 3.2%), 2023 seen at 2.1% (prev. 1.8%), 2024 seen at 1.9% (prev. 1.8%)

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