PREVIEW: ECB Policy Announcement due Thursday 15th December 2022

- **ECB policy announcement due Thursday 15th December; rate decision at 13:15GMT/08:15EST, press conference from 13:45GMT/08:45EST**
- **Consensus and market pricing look for a 50bps hike, taking the deposit rate to 2.00%**
- **Attention will also be placed on any details of the Bank's plans to shrink its balance sheet**

OVERVIEW: Despite a softer-than-anticipated headline November Eurozone Y/Y HICP print of 10% (exp. 10.4%), the release was overshadowed by an unexpected increase in the core metric (ex-food to 6.6% (exp. 6.3%, prev. 6.4%). As such, the ECB is expected to pull the trigger on another rate hike despite the uncertain economic outlook. A step down from a 75bps to a 50bps increment is expected by 45/62 economists surveyed by Reuters, whilst market pricing assigns a circa 87% chance to such a move. Chief Economist Lane has laid the groundwork for a potential slowdown in the cadence of rate increases by noting that he would be reasonably confident in saying that "it is likely we are close to peak inflation". That said, the GC does not appear to be unanimous in stepping down to a 50bps pace of tightening with Austria's Holzmann backing another 75bps increase, whilst the influential Schnabel of Germany stated that incoming data thus far suggests that slowing down the pace of rate adjustments remains limited. For several weeks, analysts at ING have been of the view that an "earlier and more significant" form of QT could be the compromise required by hawks in order to back a slower pace of rate hikes. Accordingly, ING expects the ECB to "announce a gradual reduction of the reinvestments of its bond holdings under the Asset Purchase Programme (APP) at the December meeting, with the aim to stop the reinvestments by end-2023." Looking beyond the December meeting, a further 75bps of tightening is fully priced in for 2023 which would take the deposit rate to 2.75% and into restrictive territory with policymakers broadly of the view that rates are "close to neutral".

PRIOR MEETING: As expected, the ECB opted to pull the trigger on another 75bps hike, taking the deposit rate to 1.5%. Interestingly, the accompanying statement saw policymakers drop their "several meetings" guidance with regards to future hikes. Instead, they now expect "to raise interest rates further", but without providing a timeframe. Elsewhere, the GC opted to change the terms and conditions of the third series of TLTROs and offer banks additional voluntary early repayment dates. Furthermore, the ECB opted to set the remuneration of minimum reserves at the ECB’s deposit facility rate (previously the main refi rate). On the balance sheet, despite some hopes for a tweak to guidance on QT, the Bank made no changes to its language regarding reinvestments for PEPP and APP. At the follow-up press conference, Lagarde's qualitative assessment of the Eurozone saw the President caution that activity is likely to have slowed significantly in Q3 and is expected to slow down substantially over the remainder of the year. That said, the fight against inflation will keep the Bank in normalisation mode with inflation judged to be " far too high". When it comes to further rate hikes, Lagarde stated that the GC may need to go beyond normalisation and despite dropping the word "several" from the statement, she conceded that the ECB might need to hike "at the next several meetings". On the balance sheet, Lagarde noted that policymakers did not discuss substantive APP issues, but would pursue a discussion of the key principles of APP in December, thus disappointing some who may have been looking for a more timely discussion and implementation of QT in early 2023.

RECENT ECONOMIC DEVELOPMENTS: Despite a softer-than-anticipated headline November Eurozone Y/Y HICP print of 10% (exp. 10.4%), which was dragged lower by a decline in energy inflation, the release was overshadowed by an unexpected increase in the core metric (ex-food and energy) to 6.6% (exp. 6.3%, prev. 6.4%). The December ECB Consumer Expectations survey showed "median expectations for inflation over the next 12 months increased from 5.1% to 5.4%, while expectations for inflation three years ahead were unchanged at 3.0%" The 5y5 inflation forward is currently at 2.4% vs. circa 2.37% at the time of the October meeting. On the growth front, Q3 GDP slowed to 0.3% from the 0.8% increase seen in Q2. More timely PMI data showed the November EZ Composite metric rose to 47.8 from 47.3 with the accompanying report noting "a fifth consecutive monthly falling output signalled by the PMI adds to the likelihood that the eurozone is sliding into recession. However, at present the downturn remains only modest, with an easing in the overall rate of contraction in November means so far the region looks set to see GDP contract by a mere 0.2%." In the labour market, the Eurozone unemployment rate fell to 6.5% in October from 6.6%.

RECENT COMMUNICATIONS: Since the prior meeting, President Lagarde (Nov 28th) stated that she expects the ECB to "raise rates further to the levels needed to ensure that inflation returns to our 2% medium-term target in a timely manner...How much further we need to go, and how fast we need to get there, will be based on our updated outlook". Lagarde added that "we do not see the components or the direction that would lead me to believe that we have reached peak inflation and that it is going to decline in short order". The influential Schnabel of Germany (Nov 24th) remarked

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"incoming data thus far suggests that slowing down the pace of rate adjustments remains limited", adding that the Bank will probably need to hike into restrictive territory. Elsewhere at the hawkish end of the spectrum, Austria's Holzmann continues to favour a 75bps increment, whilst Slovenia's Kazimir (Dec 7th) noted that one inflation figure is not sufficient to slow rate hikes. Germany's Nagel is of the view that QT should commence as of Q1, adding that the ECB likely doesn't need to manage a planned roll off in its bond portfolio given the “sufficient resilience” in financial markets. Chief Economist Lane (Dec 6th) has laid the groundwork for a potential slowdown in the cadence of rate increases by noting that he would be reasonably confident in saying that "it is likely we are close to peak inflation". Lane added "...in December, we should take into account the scale of what we have already done. So the basis for the decision will be different (compared to September and October)." Portugal's Centeno is also leaning in favour of a step down to a 50bps adjustment by stating (Nov 28th) that 75bps interest rate hikes cannot be the norm and he sees a lower increase in December. Elsewhere at the dovish end of the spectrum, Greece's Stournaras (Dec 1st) remarked that inflationary pressures will ease and as such advocated the ECB takes greater account of the risk of an economic crisis in monetary policy (an argument that was made by doves previously, according to the account of the October meeting).

RATES: The Governing Council is expected to deliver a 50bps hike across its three key rates taking the main refi, marginal lending and deposit rate to 2.50%, 2.75% and 2.00% respectively. A step down to a 50bps increment is expected by 45/62 economists surveyed by Reuters, whilst market pricing assigns a circa 87% chance to such a move. As detailed above, there is a hawkish contingent on the Governing Council which would prefer to stick with a 75bps cadence for the upcoming decision. However, it is expected that the argument for a 50bps adjustment will win out, with some at the October meeting having already made the case for such a move given the potential financial stability and economic activity ramifications of an “overly aggressive pace of tightening”. Comments from Chief Economist Lane (see above) have also helped to cement expectations for a smaller hike this time around. That said, it is possible that the hawks on the GC may seek a compromise on any decision around QT in order to back a 50bps hike (see below). Beyond the upcoming decision, focus will be on how committed President Lagarde sounds during the press conference to additional hikes in 2023. As it stands, a further 75bps of tightening is fully priced in for 2023 which would take the deposit rate to 2.75% and into restrictive territory with policymakers broadly of the view that rates are "close to neutral".

BALANCE SHEET: Asides from the decision on rates, much of the conversation ahead of the meeting on what plans, if any, the Bank could announce to shrink its balance sheet. As it stands, guidance for its two bond-buying programmes (APP and PEPP) reads as follows, for APP: "The Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it started raising the key ECB interest rates...". Whilst for the PEPP, "the Governing Council intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024". Focus for any decision surrounding QT will likely centre around APP with no changes expected to the Bank's plans for PEPP. Accordingly, ING expects the ECB to "announce a gradual reduction of the reinvestments of its bond holdings under the Asset Purchase Programme (APP) at the December meeting, with the aim to stop the reinvestments by end-2023." In terms of the rate at which the ECB could look to shrink its balance sheet, Rabobank suggests "based on the expected amount of annual redemptions, we estimate that it should be possible to achieve an average monthly pace of €30 billion simply by not reinvesting maturing bonds". Rabobank adds that it is unlikely that the Bank would sell any assets in the early stages of QT, noting that "if the ECB wants to accelerate or smooth the process of draining liquidity, liquidity operations could be used to augment QT".

ECONOMIC PROJECTIONS: For the accompanying macro projections, it is needless to say that they will be subject to a great level of uncertainty. However, according to consensus, published by Bloomberg, near-term inflation forecasts will likely be revised higher with 2022 forecast at 8.5% (prev. 8.1%) and 2023 at 6.0% (prev. 5.5%). For the 2024 forecast which might garner more attention on account of it being viewed as a proxy for how much tighter monetary policy might need to get, consensus looks for a downward revision to 2.1% from 2.3%. Note, we will also get the prelim forecast for 2025. From a growth perspective, 2022 GDP is expected to be upgraded to 3.2% from 3.1%, 2023 slashed to -0.1% from 0.9% and 2024 to 1.5% from 1.9%.

ECB Euro Area Real GDP Forecasts (Sep 2022):

2022: 3.1% (prev. 2.8%) 2023: 0.9% (prev. 2.1%) 2024: 1.3% (prev. 2.1%)

ECB Euro Area HICP Forecasts (Sep 2022):

2022: 8.1% (prev. 6.8%) 2023: 5.5% (prev. 3.5%) 2024: 2.3% (prev. 2.1%)

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