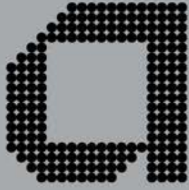

Research Institute – Europe Inside and Out

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#Europe / #Monthly / #Monetary Policy

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The ECB and BoE are both still in hiking mode

Both the ECB and the Bank of England will be raising interest rates this week, but the size of these hikes is still somewhat uncertain. Both central banks are in a tough spot – trying to bring down inflation, even as their economies slow – and it's leading to acute policy trade-offs. Even after this week's meetings, both central banks will need to hike more, before cutting later in 2023.

Key takeaways

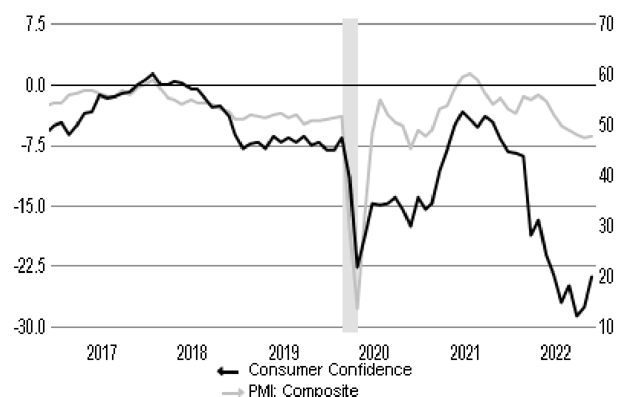
- We think the ECB will hike rates by 0.50 percentage points at its meeting Thursday, bringing the key rate to 2%. It's a closer call than it was a month ago, but the sharply slowing Eurozone economy now is likely to pull in the reins on the pace of tightening.
- The ECB will seek to de-dramatise quantitative tightening by making it passive and minimising the signalling channel between rates and balance sheet policy.
- However, it's plausible that an increase in bond market stress, especially in peripheral government debt markets, would see the ECB end its QT in the not-so-distant future.
- We expect the Bank of England to hike rates by 0.75 percentage points at its meeting Thursday. Recent speeches suggest Bank policymakers are very divided about the appropriate path of policy. But we think the persistence of underlying inflation will keep the majority in favour of a larger rate increase.

Why a half-point ECB move is more likely now

Our longstanding call is that, after hiking the deposit rate a cumulative 2 percentage points, to 1.5% over the past six months, including with two big 0.75 percentage point increases, the ECB is likely to proceed in slower increments from December, raising rates by just a half percentage point.

However, we've also said that a 0.75 percentage point hike is not off the table. Several recent developments have kept alive the possibility of another big hike. The **first** is slightly better-than-expected activity data. The Eurozone composite purchasing managers index (PMI), which broadly tracks the health of private-sector companies, nudged higher in November, rising 0.5 points to 47.8. Consumer confidence has also improved (see Figure 1). And German industrial production (IP) data for October declined remarkably little, by just 0.1% compared to the month before, which given Europe's energy headwinds is reasonably resilient.

Figure 1: Eurozone survey data for November inched up, but remain exceedingly depressed



Source: Haver, abrdn, December 2022

The **second** is a speech by influential ECB Governing Council member Isabel Schnabel, in which she said "the room for slowing down the pace of interest rate adjustments remains limited". The account of the previous meeting also had a somewhat hawkish tone.

However, on balance we still think a step down to half-point increments is more likely. For a start, after recent oscillations, it's now what the market expects. At the time of this writing, market pricing incorporates a 75% probability of a half-point hike, and a 25% probability of a 0.75 percentage point hike. The ECB may not want to surprise markets.

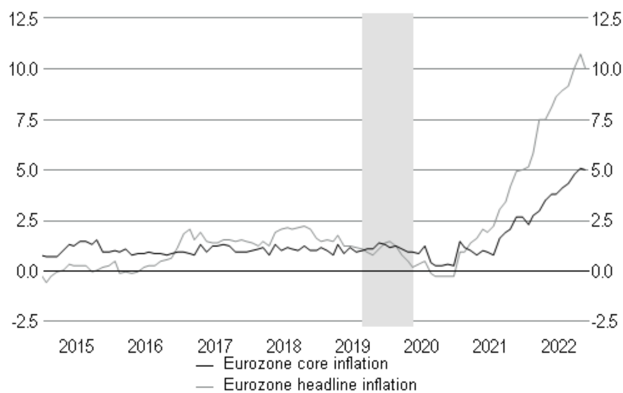
More fundamentally, the new staff macroeconomic projections are likely to incorporate a Eurozone recession for the first time. That said, they may still remain more optimistic than our own forecasts.

What's more, Eurozone inflation may have peaked and may be starting to drop back. The euro area's flash estimate for the harmonised indices of consumer prices (HICP) for November fell to 10.0%, from 10.6% previously. This is the first decline in Eurozone inflation in 18 months and reflects lower energy prices.

Unless there's another big run-up in gas prices – which by the way we're not expecting – headline inflation should drop sharply over 2023. By the fourth quarter of next year, our forecast is for around 3% headline inflation.

Nevertheless, core inflation, the measure that excludes the more volatile food and energy prices, was unchanged in November, at 5.0%, and that's too high for the ECB. We expect core inflation to fall in 2023, but we see it doing so at a much slower pace than headline. For now, this will keep the ECB in hiking mode – heading toward our forecasted 2.5% terminal policy rate.

Figure 2: Eurozone inflation has started to drop back



Source: Haver, abrdn, December 2022

How to think about ECB "quantitative tightening"

It'll be important to watch what the ECB has to say about quantitative tightening (QT) after this meeting. The central bank, at its last meeting, committed to using this time to discuss the "key principles" of the reduction in the stock of asset purchases.

Details may remain light, but we suspect the ECB wants to de-dramatise QT so that it has as little impact as possible on the economy and the market.

That probably means doing QT passively (i.e. by allowing maturing assets to just run off the balance sheet, rather than actively selling assets). The ECB will also want to remove the "signalling" channel through which QE largely worked – that is, there will be no "read across" from QT to the path of the policy rate.

While all this may mean QT has little market impact at first, we caution that things could change, especially if there's a period of bond market stress caused by unforeseen shocks, especially during the recession.

For example, renewed Italian sovereign debt stress might see the ECB's Transmission Protection Instrument – its bond purchase scheme aimed at helping more indebted euro zone countries – become less credible, as it would add to doubts about policymakers' willingness to re-launch net asset purchases. In fact, the likelihood of such an episode at some point is why we don't think QT will continue for all that long in the Eurozone.

Bank of England policymakers still seem deeply divided

Like the ECB, the Bank of England at its next meeting is effectively facing a decision of whether to hike rates by 0.5 percentage points or 0.75. However, the distribution of votes among the Bank's Monetary Policy Committee is likely to show an even wider spread of possible outcomes, reflecting the difficulties of balancing the many different shocks hitting the UK economy.

On the dovish side, it seems likely that Silvana Tenreyro and Swati Dhingra will vote for at most a 0.25 percentage point increase, and at least one of them may vote for no hike at all. Meanwhile, on the hawkish side, both Catherine Mann and Dave Ramsden are very likely to vote for a 0.75 increase. The outcome will therefore turn on whether the core of the committee – Andrew Bailey, Ben Broadbent, and Huw Pill – decide to vote for a 0.5 move or 0.75.

It's shaping up to be a finely balanced decision, but we are minded to stick with our forecast of a 0.75 percentage point hike.

While the economy is clearly slowing, there has been little evidence that underlying inflation pressures are receding. Wage growth is running ahead of the Bank's forecasts, and services inflation seems to be strengthening. The labour market, while a lagging indicator, has shown little sign of the sustained cooling needed to bring underlying inflation to heel.

We are also unconvinced by the framing of the 0.75 point hike in November as a one-off emergency move, sufficient to restore the Bank's (and indeed the UK's) institutional credibility after the ill-fated mini-budget. There is scant

reason to think a single 0.75 move is sufficient to re-anchor inflation expectations.

However, the fact that the Bank has done little to guide the market toward pricing a big 0.75 percentage point move in December is probably the strongest reason to think a slowdown to a 0.5 move is coming. The Bank may be loath to surprise the market, especially in a hawkish direction, when it has been trying to manage down long-run rate expectations.

Either way, we continue to expect Bank Rate to rise to a terminal level of 4.5% next year. This is broadly consistent with market pricing, after a large downward repricing over the past month. Most Bank policymakers probably still think this is excessive, but this meeting is unlikely to see anything like the degree of pushback against the market that the November meeting saw.

Our latest Eurozone and UK forecasts

- **Activity:** Despite some modest upside surprises in Eurozone activity data, what the bigger picture tells us is that the recession is underway. However, Europe should be able to avoid gas rationing this winter, and because of that, we've actually revised our forecasts upward. The UK economy contracted in the third quarter, in part because the extra bank holiday in September weighed on output. This is likely to be the first of several consecutive quarters of contraction, and so in that sense, it marks the beginning of the UK's recession. However, when you look beyond the technical quirks, the fourth quarter seems likely to be the beginning of a more fundamentally driven contraction in the UK economy.
- **Inflation**: Eurozone inflation surprisingly fell back to 10.0% in November, its first decline in 18 months, as energy prices eased lower. We forecast headline inflation as low as 3% by the end of 2023, but we expect the core rate to be stickier. UK inflation probably peaked in November, with the energy price cap keeping inflation from rising as high as it otherwise would have. Base effects will pull headline inflation down next year, but the underlying inflation pressures will still be stickier.

  Monetary policy: We expect the peak terminal ECB deposit rate to reach 2.5% in 2023, before the start of a cutting cycle later in the year. We expect the Bank of England to deliver 1.5 percentage points of further hikes by early next year, before easing rates lower later in the year.

	2021	2022	2023	2024
Eurozone				
GDP (%)	5.3	3.1	-1.4	1.0
CPI (%)	2.6	8.6	5.7	2.3
Depo Rate (%)	-0.50	2.00	1.75	0.0
UK				
GDP (%)	7.5	4.3	-1.7	0.5
CPI (%)	2.6	9.0	5.9	2.4
Bank Rate (%)	0.25	3.75	2.25	0.1

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