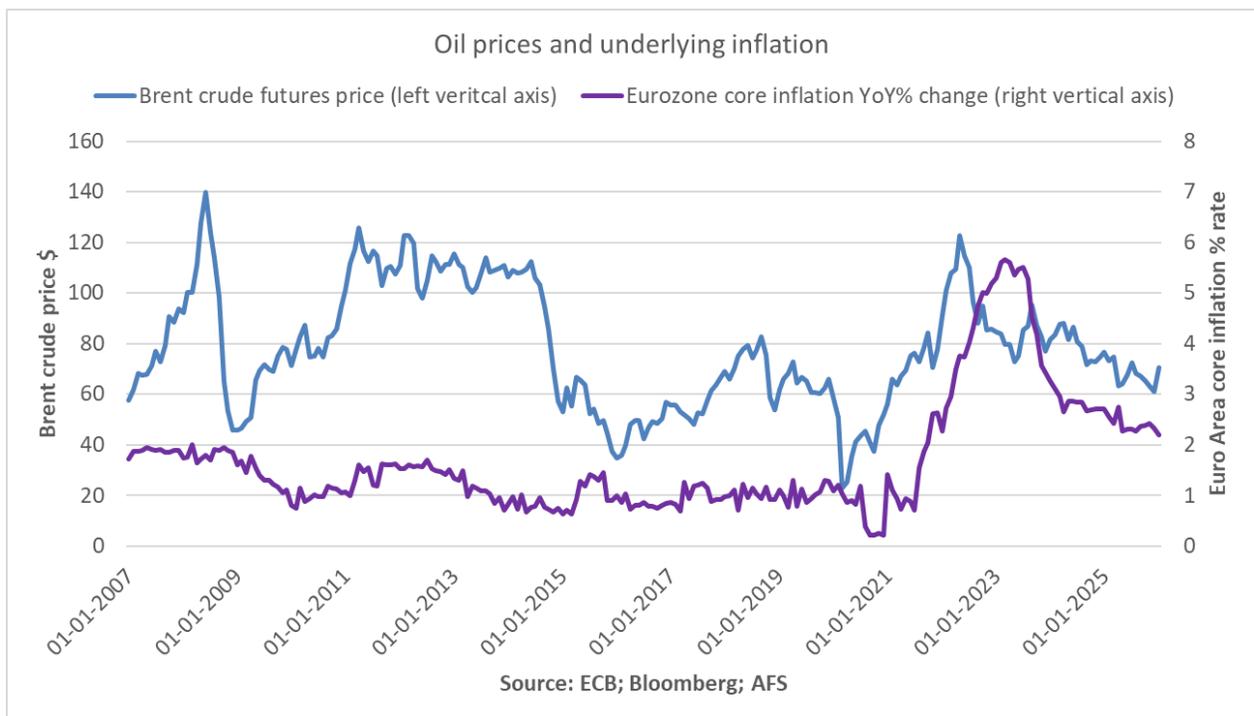


Research

The ECB won't flag rate hikes for the April and June meetings

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- **On Thursday, the ECB will probably say loud and clear that it's in a good position to confront the energy price shock stemming from the war in Iran.** But don't interpret those remarks as a tee-up a rate hike for the April or June meetings (for the record: Thursday will be hold). Yes, the ECB will tilt hawkish on Thursday – it's forced to do so by circumstances outside of its control: the force of nature that is US President Trump. But there's a case to be made for holding rates through the current geopolitical storm.
- **This is not 2022.** Rather, the current shock resembles the pre-recessionary energy price shocks of 2008 and 2011. In both cases, the ECB raised rates during a late-cyclical energy and commodity driven price shock. In both cases, rate hikes sealed the economy's fate. Ironically, the chart below shows that core inflation remained at benign sub-two percent levels. Though we don't know about the counter-factual – if the ECB had kept policy unchanged.



- **Notice how in 2022 core inflation did rise in tandem with crude prices.** However, unlike what the central bankers tell you – who only blame the supply side – I think the inflation surge of 2021-2022 was by and large the result of excessively easy fiscal and monetary policies in response to the pandemic. But you will never hear a central banker say that – *Omerta* and all that.
- **So yes, this is not 2022.** Before the 2022 rate hike cycle, financial and monetary conditions were easy. Currently, they can hardly be described as easy. According to the ECB latest quarterly Bank Lending Survey, demand from firms and households for bank loans is tepid while credit standards and terms and conditions were tightened. A far cry from the easy money (overhang) of 2021.
- **The picture is the same for pricing power of firms and households.** The table below shows selling price expectations of firms according to the EU Commission’s monthly business and consumer survey. I compare the post-pandemic boom and hangover with the first months of this year. A positive number means that a greater percentage of firms expect to increase selling prices.

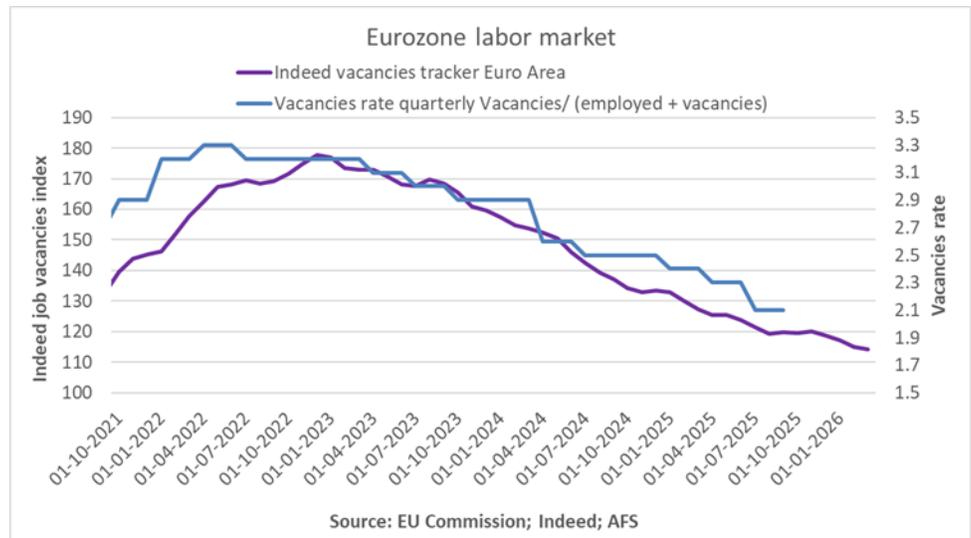
Month	Selling price expectations industry net percent.	Selling price expectations services net percent.	Selling price expectations retail trade net percent.
31-07-2021	35.5	13.7	27.5
31-08-2021	36.9	13.3	28.7
30-09-2021	37.8	14.5	31.8
31-10-2021	41.3	17.4	38.1
30-11-2021	49.4	20.3	45.5
31-12-2021	47.2	19.9	42.4
31-01-2022	46.2	21	42.7
28-02-2022	48.4	23	47.5
31-03-2022	57	26	54.7
30-04-2022	59.9	30.6	56.5
31-05-2022	56.3	29	57.3
30-06-2022	51.5	28.9	58.2
31-07-2022	45.8	27.5	55.5
31-08-2022	44.1	26.3	53.3
30-09-2022	49.5	28.9	54.4
31-10-2022	44.7	30.1	55.8
30-11-2022	40.5	29.7	51.7
31-12-2022	37.2	27.6	48.3
31-01-2026	10.3	14.1	16.0
28-02-2026	11.5	13.9	16.1

Current readings are in line with the historical pattern of a modest to moderate net percentage of firms expecting price increases.

- **Regarding the labor market, firms were hiring like crazy in the wake of the pandemic-induced labor shortages.** Below are firms’ employment expectations according to the same EU Commission survey. Outside of construction, the employment outlook is soft, with marginal job shedding in the manufacturing sector.

Month	Employment expectations manufacturing net percent.	Employment expectations services net percent.	Employment expectations construction net percent.
31-07-2021	13.4	13.1	23
31-08-2021	13.1	13.5	24.3
30-09-2021	13.6	14.9	25.4
31-10-2021	15.1	15.5	27.2
30-11-2021	15.5	16.4	28.2
31-12-2021	16.7	11.7	29.3
31-01-2022	16.9	10.9	28
28-02-2022	18.3	15.3	26.9
31-03-2022	11.1	13.8	27.6
30-04-2022	10.6	13.0	28.7
31-05-2022	11.7	14.7	27.6
30-06-2022	10.5	13.2	26.9
31-07-2022	9.9	11.0	29.8
31-08-2022	8.1	12.0	30.7
30-09-2022	6.6	11.2	30.1
31-10-2022	7.0	7.8	29.1
30-11-2022	7.5	10.7	29.2
31-12-2022	7.8	10.3	28.7
31-01-2026	-3.4	1.2	25.1
28-02-2026	-3.5	0.2	24.9

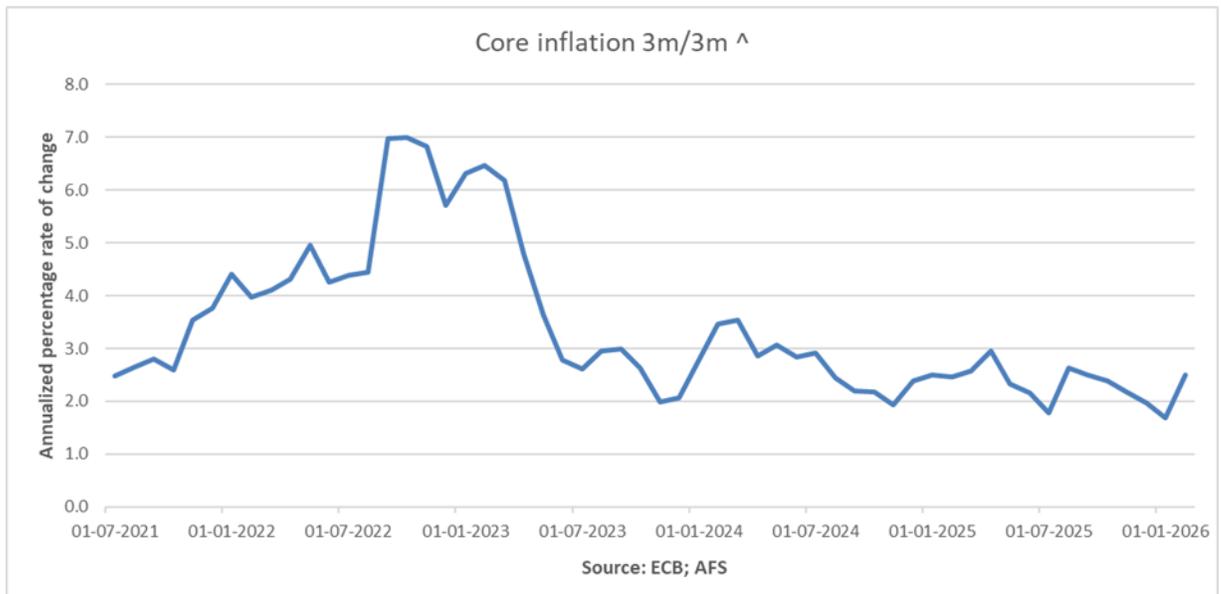
- **The trend in vacancies confirms that this is not the 2021-2022 labor market bonanza, when firms would hire anyone with a pulse.** According to the Indeed vacancies tracker, the timeliest piece of labor market data for the Euro Area, outstanding vacancies track lower and lower every month. Expect the official vacancies data from Eurostat to confirm what Indeed is telling us almost in real-time.



- **Finally, what about demand?** Manufacturers see demand shrinking, which is offset by moderate demand growth for services providers. Expected demand in the retail sector is tepid.

Month	New orders manufacturing net percent.	New orders services net percent.	Expected demand retail net percent.
31-07-2021	12.6	21.3	9.8
31-08-2021	11.5	19	9.9
30-09-2021	11.9	21.2	8.5
31-10-2021	12.5	23.6	10.1
30-11-2021	14.3	21.2	8.5
31-12-2021	14.5	13.6	5.5
31-01-2022	13.8	14.3	5.2
28-02-2022	14.1	20.4	6.4
31-03-2022	13.1	13.9	0.5
30-04-2022	12.8	14.3	-2.4
31-05-2022	7.5	14.5	-0.8
30-06-2022	9.9	12.8	-2.9
31-07-2022	5.6	9.9	-4.1
31-08-2022	1.7	10.2	-6.1
30-09-2022	1.8	6.7	-9.8
31-10-2022	0.6	4.5	-10.2
30-11-2022	-2.5	7.2	-10.5
31-12-2022	-2.1	9.7	-6.1
31-01-2026	-21.2	11.1	-2.7
28-02-2026	-21.1	9.8	-2.6

- I must emphasize that the EU Commission survey used in the table above is probably a bit too negative on manufacturing if the PMIs are any guide.** Regardless, both the EU Commission survey and the PMI tell us the same thing: this is not the strong hot economy that we experienced during the 2021-2022 reopening phase. Real GDP growth nowadays is only a tad above one percent, and survey data suggests that growth will either remain that way or increase a wee bit. The labor market remains a worrisome sore spot.
- Of course, the ECB targets inflation and not nominal output.** And therein lies the rub. The ECB has hit its inflation target ‘from above’. Core inflation is at 2.2 percent or thereabout. Close enough for the ECB to claim it has met its target of two percent. But clearly, it leaves no room for error. Regardless, we’re not in 2021-2022 territory. Back then, by July 2021, annualized core inflation had already increased to 2.5 percent. Mind you: that was *before* the energy price shock:



- According to the Bank of Italy, the energy price shock of 2022 (and 2022 alone) [added 0.8 percentage point to core inflation through so-called second-round effects](#). While that may sound like a lot – it is – it doesn’t even come close to explaining core inflation rising to a lofty seven percent annualized, which was simply the result of money printing.
- The table below shows the percentage increase from year-end pre-energy crisis to peak, allowing us to gauge the impact on core inflation in the present. I use monthly average prices for crude oil and natural gas because Eurostat averages prices throughout the month to compute the price indices for energy.

	Crude oil	Natural gas
2007-2008	47	--
2010-2011	57	--
2021-2022	53	106
2025-2026	49	84

For the record: the current price spike will boost headline inflation by about two percent – so to four percent over the course of the year according to my own estimates.

- The current crude oil spike resembles those of 2021-2022, 2010-2011, and 2007-2008 in severity. Natural gas price haven’t increased as much as they did in 2021-2022. Furthermore, the table only captures the natural gas price increase in 2022, not the price increase from late 2021. That’s because I want a clean comparison with the Bank of Italy’s research on the pass-through of energy prices in core inflation (there’s only a pass-through figure for 2022).
- Dissecting the 0.8ppt second-round effects increase in core prices from the 2022 energy price shock, according to the Bank of Italy there was a 0.3ppt boost from higher natural gas prices; 0.2ppt from higher crude oil prices; and 0.3ppt from higher electricity prices. This time around, electricity prices are broadly stable. So, that leaves us with a 0.5ppt pass through.

- **Now, if we assume that crude oil and natural gas prices will increase as much as they did in 2022, and with the same demand elasticities, core inflation should rise to 2.7 percent.** However, the Bank of Italy's estimate assumes a high pass-through scenario, which is fitting for the 2022 situation, when demand was strong, and supply was hampered by pandemic lockdowns and whatnot. With a clearly weaker economy, neutral monetary policy, and only modestly easy fiscal policy, the pass-through to core inflation should be a few tenths of a percentage point lower. Core inflation should rise to 2.5 percent, give or take a few tenths of a percentage point, with risks to the upside from higher food inflation.
- **Bottom line: with only a relatively modest increase in core inflation expected to still manageable levels, I see no reason for the ECB to guide for a rate hike at the next several meetings.** Yes, they will obviously turn hawkish on Thursday, but they will stop at that. If oil and gas prices hold steady at current levels, they will hold in April as well. And in June, a rate hike only becomes an option if the war hasn't ended already or won't end soon. And if the war ends and the situation in the Strait of Hormuz slowly normalizes, why would the ECB hike instead of looking through what is likely to be a temporary bump in core inflation?
- **In my latest contribution to the Bloomberg poll, I have penciled in no hikes for this year.** I am sticking to that call unless the ECB or the war gives me reason otherwise. I must warn you though: I cannot rule out a rerun of the 2008 and 2011 hikes. Which, by the way were fully reversed months after they took place.

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