Update of an event with investors, February 14th 2022

On January 20th I published a post on this blog, reporting on an event with investors in which I expressed a somewhat tighter position than the then prevailing one of the ECB.

A brief recollection of events since then is useful to update my view on the ECB:

- On February 2nd it was communicated that inflation in the euro area instead of coming down went up to 5.1%
- On February 3rd at the press conference, President Lagarde came with a distinctly more hawkish tone than before. I also uynderstood she also nearly preannounced a change of inflation projections for 2023 and 2024 at the March press conference, arguably to >2%.
- 2 y OIS rates have increased in the euro area by 10 basis points and the last time I looked at money market rates they indicated that by the end of the year they would move away from the negative area. GS, among other, thinks the ECB would exit NIRP by the end of the year.
- On February 7th at the EP, President Lagarde rowed back a little, having seen the arguably excessive market impact
- On February 10th inflation in the US reached 7.5%
- Between 5 and 7 quarter point increases are expected in the US. 50 bp increases are considered plausible
- In February the IMF came out with inflation forecasts of 3.0 1.7 1.8 1.8 1.8 for 2022-2026 for the euro area, critically below the 2.0 bar as from next year
- Similarly, the EU Commission in its winter forecasts expects inflation to reach 3.5% in 2022, but then to move to 1.7% in 2023.
- Governor Knot is in favour of an increase by 25 bp of rates before, but close to, the end of the year while ending purchases asap
- Governor Makhlouf, expects an end of purchases in June or a few month later and only a rate increase after that, pushing against market expectations of an increase in June
- Governor Rehn pronounced himself for a cautious attitude towards exit from the very easy policy
- Unemployment in the euro area reached 7.0% in December 2021, lower than before the pandemic and very low in historical terms
- Participation rate in the euro area is higher, at 74.5 %in the third quarter of 2021, than 73.7 at the end of 2019
- Employment is very close to where it was before the pandemic
- Wage growth, while not easy to read, is estimated to be around 2%.

How do we interpret this mixed bag of news?

I draw two conclusions. On the first one I have nearly 100% confidence, on the second one my confidence level is lower, maybe 2/3.

The first conclusion is that the macroeconomic situation is very uncertain as shown by:

- Changes and surprises in macroeconomic variables (GDP, Inflation, employment)
- Changes and surprises in financial conditions (OIS)
- Differences across institutions and over time of economic forecasts
- Unusual relationships (wages – unemployment; prices - wages)
- Changes in statements from central banks.

The second conclusion, on which I have less confidence, is that I don't see the need to change significantly my January 20th expectation. To recall, this was:

- *End of APP net purchases towards the end of 2022*
- *Small change in official rates (deposit in particular) before the end of 2022 is likely*
- *Moving forward guidance towards YCC a la BoJ*
- *Rate increases continuing in 2023, finally moving away from negative domain*

Overall a somewhat tighter scenario than put forward by the ECB, Lane in particular.

I also said that that expectation should be moved into the tight direction in case of unfavourable inflation news, which indeed we have seen

I would therefore tweak my January 20th expectations in the tightening direction:

- The change in the deposit rate could be 25 bp, not small
- End of APP purchases earlier than "towards the end of 2022", say in the third quarter of the year.

I still believe only one rate increase in 2022 and exit from NIRP only in 2023, moving forward guidance towards YCC a la BoJ, as specified on January 20th.

On Italy, just one comment: I find excessive the emphasis on ECB purchases as mover of the spread, and eventually on debt sustainability. I put more weight on what Italy will do, especially in terms of potential increase of the growth rate but also on fiscal policy.