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EUROPEAN CENTRAL BANK: LAST DOVE STANDING?

2 February 2022

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Executive Summary

- *Despite large inflation upside surprises since the last policy meeting, with the January HICP release registering the largest upside surprise ever, we think the ECB will maintain its monetary policy stance—for now. Supply-side effects, especially energy prices, are still the key inflation drivers while second-round effects—inflation expectations and wage growth—remain moderate. The ECB's lift-off conditions for raising rates are still unlikely to be met this year, especially given the ECB's tolerance for temporary inflation overshoots as a key result of its recent Strategy Review.*

- *We expect that the ECB will start "real tapering" (i.e. winding down the general asset purchase program) in January 2023, followed by a 25bps rate increase in September 2023. QE effects will limit the upside potential for long-term yields for many years. Once "real tapering" starts, it should not be interpreted as a signal that the ECB will soon loosen its grip on the term structure of Eurozone yields. Tapering is just a new phase of QE where the decisive parameter shifts from net purchases to reinvestment policy. In a three-year full reinvestment scenario, it will take 10 years before the 10-year German Bund yield will return to its long-term average of about 1.5 percent.*

- *However, the ECB's current forward guidance gives little room for maneuver if inflationary pressures become more broad-based and entrenched. A hawkish policy shift might need to be quite aggressive, including inverting the current exit sequencing—hiking while continuing with QE, which could raise the risk of increasing dissent in the ECB Governing Council.*

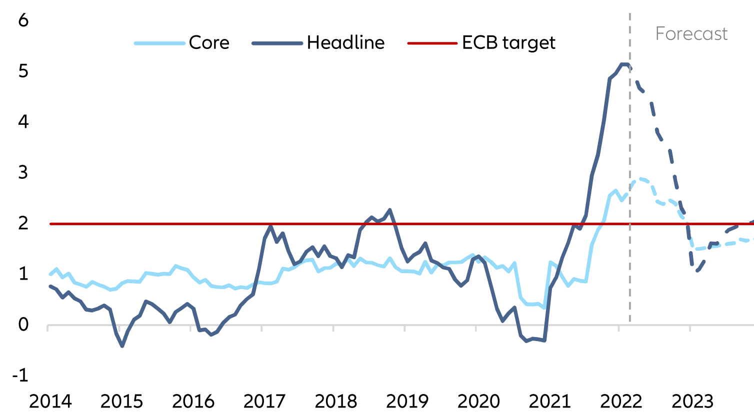
- *Looking towards the medium-term beyond the current challenge of effective forward guidance, we expect the hiking cycle to be very shallow, suggesting that there will be little tightening in real terms. We see the terminal rate of 0 % by end-2025—still substantially below the natural rate. So the upcoming tightening cycle is just a phasing-out of the current crisis mode rather than a clear departure from the accommodative monetary stance.*

At tomorrow's Governing Council meeting, the ECB will likely reconfirm its 2022 policy plan, increasingly standing out as a late bloomer when it comes to reigning in monetary policy support compared to the Fed (and

most other central banks). Last week, the US Federal Reserve delivered a very hawkish policy meeting, with the rate lift-off announced for March (when tapering will end) and balance sheet reduction likely to follow as soon as Q1 2023. We believe that the urgency of a similarly hawish tilt is far less pressing for the ECB. Fundamentals and recent inflation dynamics help explain the growing policy divergence: The US and the Eurozone share similar drivers of current inflationary pressures, especially higher energy prices and goods supply bottlenecks amplified by catch-up demand, which boosted official core measures as prices for furniture, appliances and cars, as well as housing, have risen significantly. However, the inflation dynamics are quite different on either side of the Atlantic:

- In the US, headline inflation (as measured by personal consumption expenditure (PCE)) exceeded 7% y/y in December, more than 2pp above the consumer price index (CPI) in the Eurozone (Figure 1). Core inflation stood at 4.9% compared to 2.6% in the Eurozone, and long-term inflation expectations (measured by the 5y5y swap rate) have moved considerably more than in Europe (2.4% vs. 1.7%, Figure 1). We expect core inflation to drop further (together with greater divergence across member states in terms of non-energy core goods inflation) amid moderate services inflation (below or close to 2%).

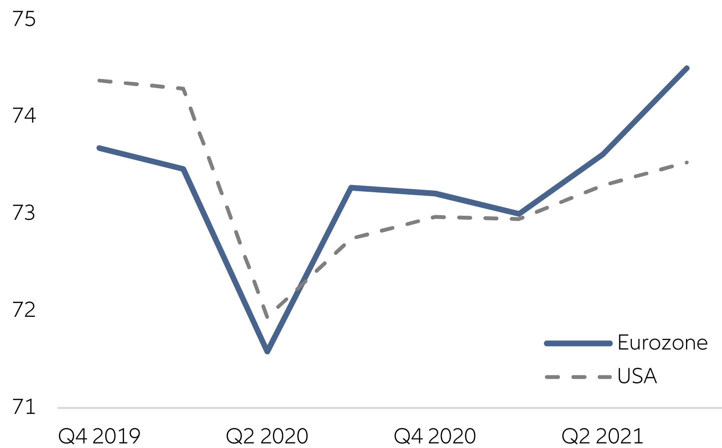
Figure 1: Eurozone inflation – headline and core HICP (y/y, in %)



Sources: Refinitiv, Allianz Research

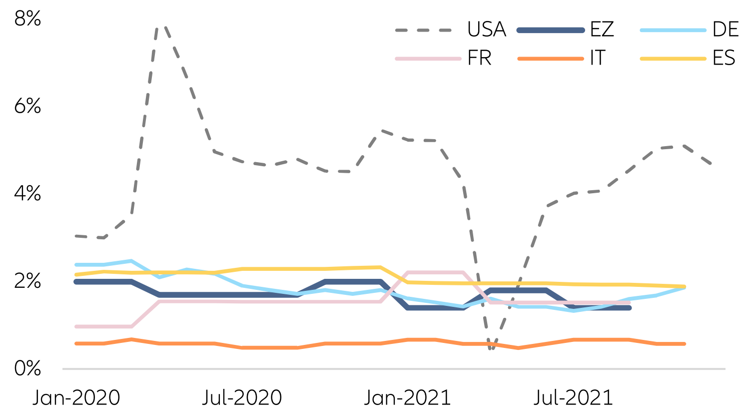
- In addition, labor market conditions are much tighter in the US, where the sharp drop in the labor force participation rate and declining employment since have pushed down the unemployment rate to pre-crisis levels. In contrast, while there are some sectors with a shortage of workers, labor force participation in Europe has increased and there is still some slack in the labor market, especially in low-growth service sectors where labor reallocation during the pandemic has been slow. While wage growth in Europe has been spotty and consistent with historical experience, in the US, wage growth – even adjusting for composition effects from the layoffs of low-wage workers – has been much faster. For the first time, wages of low-skilled workers have increased more than those of highly-skilled workers (Figures 2 and 3).

Figure 2: Eurozone and US – labor force participation rate (in %)



Sources: Refinitiv, Allianz Research

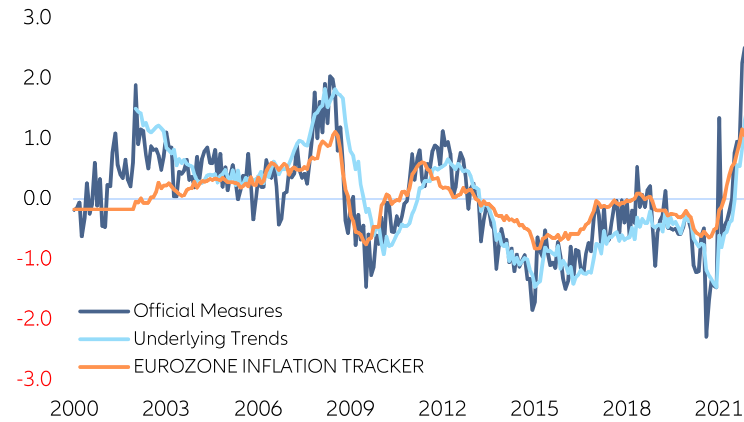
Figure 3: US and Eurozone – wage inflation (y/y, in %)



Sources: Refinitiv, Allianz Research

In this context, the ECB's lift-off conditions are therefore unlikely to be met this year – leaving aside potential shocks from further virus mutations or the escalation of the Ukraine crisis (with knock-on effects on the oil and gas supply to Europe). Even though Eurozone inflation has risen more than expected, and above-target rates look set to prove stickier than previously anticipated, we continue to view most of the inflation surge as non-structural and expect annual inflation to decelerate over the coming months as supply-chain disruptions fade and energy prices normalize, declining towards the target at the end of 2022 (Figure 4 and Appendix). Most importantly, though we see little evidence of second-round effects in Europe as inflation expectations remain largely anchored, labor market slack should keep upward pressure on wages, and in turn core inflation, in check in the medium-term.

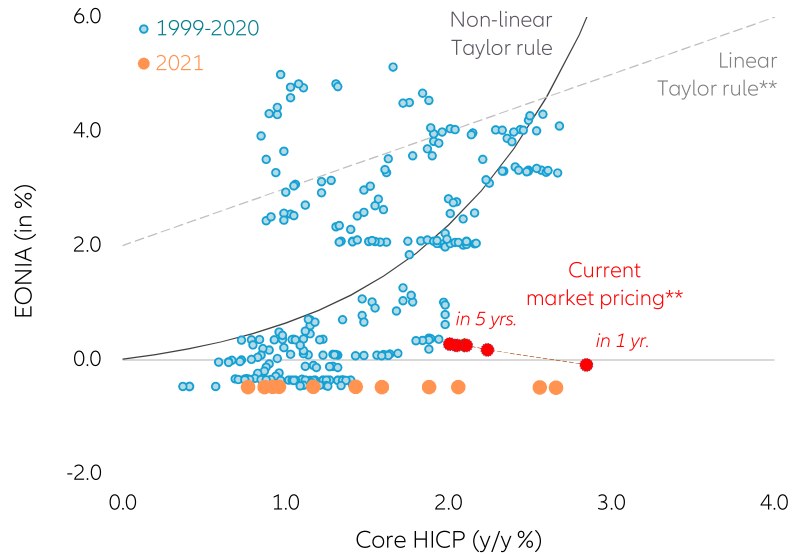
Figure 4: Eurozone – official inflation, underlying trends and inflation tracker



Sources: Refinitiv, Allianz Research

Note: Our composite measure of inflation ("Inflation Tracker") is an equally weighted and normalized measure comprising 15 sub-segments: underlying trends (modified/trimmed measures), forecasts, market-based inflation measures, expected inflation implied by term structure models, monetary aggregates, consumer and producer price components, labor market indicators, commodity prices, corporate margin & profitability and proxies for the price effect from supply-chain disruptions). See Appendix.

Figure 5: Eurozone — monetary stance vs. market pricing



Sources: Refinitiv, Allianz Research

*Note: HICP = harmonized indices of consumer prices, */ based on market expectations of inflation and short-term rates one and five years in the future, **/ based on the Fisher equation of the natural interest rate and the inflation target (2%).*

The December meeting underscored the ECB's tolerance for temporary inflation overshoots as a key result of the symmetric interpretation of the price stability target under its recent Strategy Review. Looking at the ECB staff inflation projections, which forecast headline inflation at 3.2% in 2022

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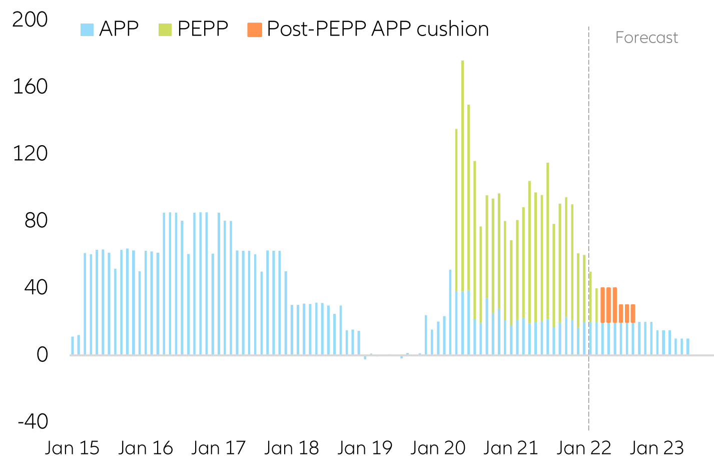
and 1.8% in both 2023 and 2024, the previous inflation target of "up to but below 2%" would arguably have been met already. Hence, the Strategy Review has enabled the ECB to maintain a more dovish policy stance. This won't be a walk in the park: Market expectations of a rate hike as early as 2022 do not fit with the ECB's current forward guidance.

We expect that the ECB will strengthen its forward guidance in the hope that markets will finally start listening (Figures 5 and 6). In the December meeting, the GC decided to conclude PEPP in March, followed by a temporary "APP cushion", which effectively rules out rate hikes until end-2022, before purchases drop back to the EUR20bn underlying APP pace, ending in Q4 2023 (and with an extended reinvestment period for PEPP until end-2024). We expect the ECB to start "real tapering" (i.e. winding down the APP program) in January 2023 and to conclude by mid-2023, followed by a 25bps increase in the deposit rate in September 2023—the first rate hike since summer 2011 and the beginning of the first meaningful hiking cycle since late 2005—1.5 years after the Fed. It is very unlikely that the GC would want to invert the exit sequencing—and hike while continuing with QE—for institutional, economic and legal reasons.

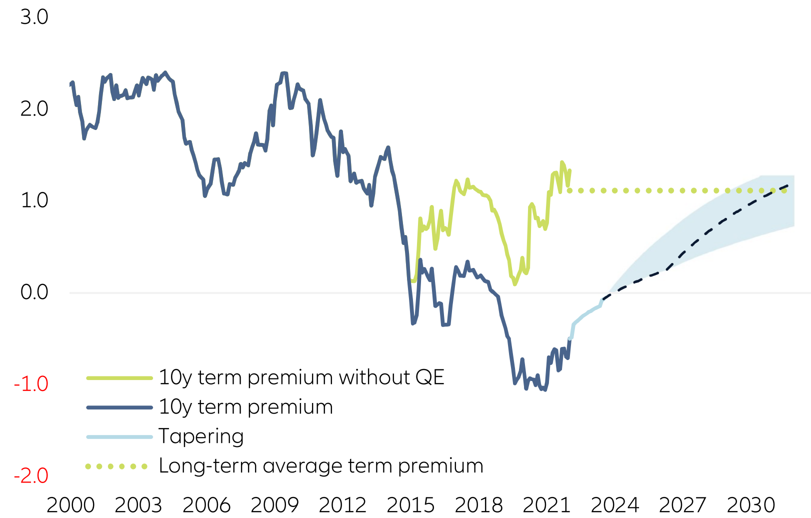
Figure 6: Eurosystem asset purchases (EUR bn)



Sources: Refinitiv, Allianz Research

QE effects will limit the upside potential for long-term yields for many years. Once tapering really starts, it should not be interpreted as a signal that the ECB will soon loosen its grip on the term structure of Eurozone yields. Tapering is just a new phase of QE where the decisive parameter shifts from net purchases to reinvestment policy. As of today, QE compresses 10y Euro yields by 185bp (via the duration extraction effect on the term premium). In a three-year full reinvestment scenario, the compression would reach 70bps in five years. It will take 10 years before the term premium would return to its long-term average (Figure 7). Long-term yields will be defined by the full reinvestment period, market neutrality and the reinvestment mix between public and corporate debt rather than the rate outlook.

Figure 7: Impact of asset purchases on the term premium of 10-year German sovereign bond yield (in %)

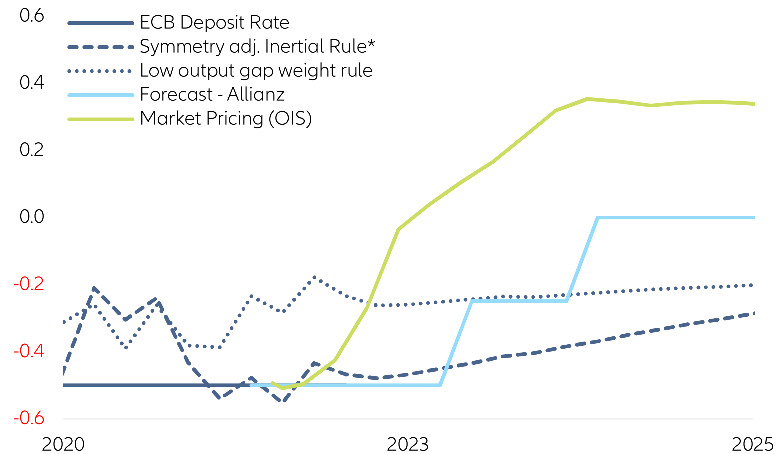


Sources: ECB, Refinitiv, Allianz Research

*Note */ with current weighted average maturity of APP+PEPP portfolio, in basis points using an adapted version of the model of Eser and others (2019)*

Looking towards the medium-term, we expect the hiking cycle to be even more shallow compared to the US one, suggesting that there will be little tightening in real terms. We see the terminal rate of 0.0% by end-2025—still substantially below the natural rate. Therefore the upcoming tightening cycle is just a phasing-out of the current crisis mode rather than a clear departure from the accommodative monetary stance that already prevailed before the Covid-19 crisis (Figure 8).

Figure 8: Eurozone policy rules, market pricing and forecasts (in %)



Sources: Refinitiv, Allianz Research

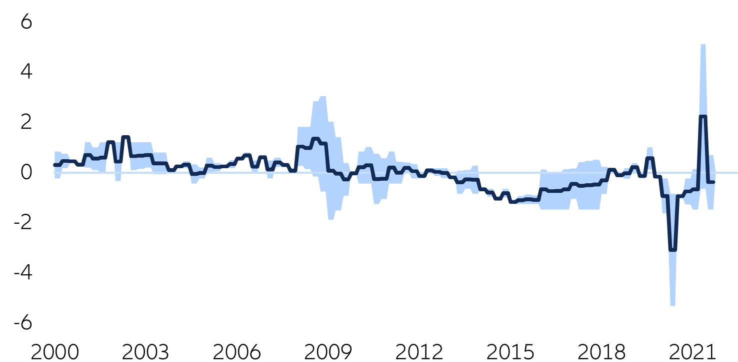
*Note: */ The inertial rule accounts for the recently amended symmetric interpretation of the price target suggesting that the ECB would tolerate temporary inflation overshoots (rather than being historically bound to keep inflation close to but not above 2%).*

However, developments over the past six weeks have challenged the current forecast. The ECB's taper announcement in December was predicated on inflation declining steadily this year, falling below the 2% target by the end of the year and remaining below target in 2023. Since the last GC meeting, inflation has further surprised on the upside, with the HICP reaching an all-time high of 5.1% in January. Upside risks for inflation —notably related to prolonged supply chain stress and elevated energy prices (fueled in part by rising geopolitical tensions)—have yet to show signs of receding. The starting point for inflation in 2022 is higher as the long-anticipated drop in Eurozone headline inflation in January did not materialize.

The ECB's March meeting—when confronted with fresh macroeonomic projections—might provide an opportunity to revisit the monetary stance in light of continued inflationary pressures. Even if the case for tightening might not be as clear cut as in the US, the ECB might choose to be preemptive if inflationary pressures become entrenched. If the recovery remains on track and labor market dynamics strengthen further, the tapering timing and speed could surprise on the earlier and swifter side. More specifically, several factors could trigger a more hawkish monetary stance:

- *Rising inflation expectations and wages.* The "de-anchoring" of inflation expectations would require raising rates sooner to mitigate the risk a self-fulfilling prophecy of higher inflation (as workers and firms start raising prices and wages on the assumption that everyone else will be doing so). Wage growth has so far been consistent with previous bargaining rounds and current union agreements have been relatively modest, focused on one-off pandemic payments instead of permanent income increases. However, current German wage negotiations—with key rounds taking place in autumn—could become a harbinger of accelerating wage dynamics if the labor market tightens further and pandemic uncertainty abates (Figure 9 and Table 1).

Figure 9: Eurozone – wages and labor market composite index and range of underlying indicators (normalized; z-score)



Sources: Refinitiv, Allianz Research

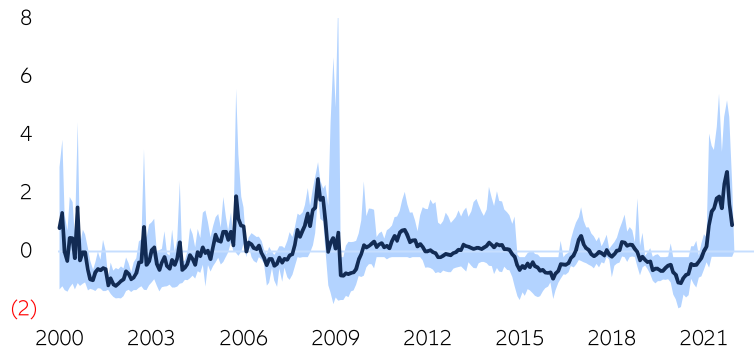
Table 1: France, Germany and US – wage growth (y/y; in %)

	2021	2022	2023
France	1.5	2.5	2.3
Germany	1.7	2.6	3.3
US	2.6	4.7	3.8

Sources: Refinitiv, Allianz Research

- *Higher energy prices*. Supply constraints on gas and oil (also potentially triggered by the current Ukraine crisis), together with persistent supply-chain disruptions, could yet combine to strain confidence in low inflation and could push up long-term inflation expectations. While the ECB would look through negative shocks from higher energy prices—because they are either temporary, or, even when permanent, they imply higher aggregate prices rather than rising inflation—it might nevertheless act to prevent higher inflation from becoming embedded (Figure 10).

Figure 10: Eurozone – energy prices composite index and range of underlying indicators (normalized; z-score)

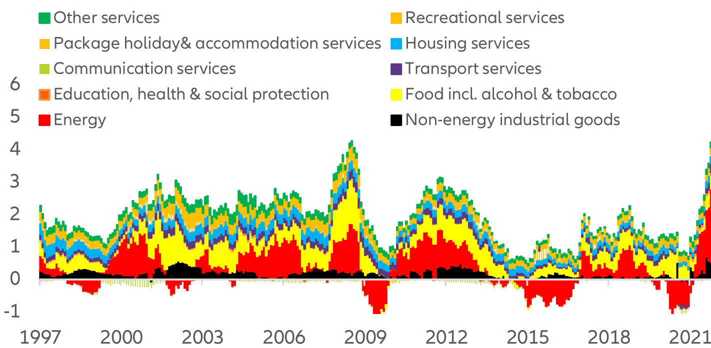


Sources: Refinitiv, Allianz Research

- *Broadening of inflationary pressures*. So far, drivers of rising headline inflation have been concentrated in the sectors and goods most affected by higher energy prices and supply-chain disruptions. However, if price pressures become more broad-based (similar to the US), it would require moving forward the timing of the first rate hike (Figure 11).

- *Exchange rate and spillover effects*. Rising real rates in the US affect financing conditions in Europe through the exchange rate channel as the euro depreciates and the price of tradable goods increases, raising overall inflation. Even though the semi-elasticity of inflation to the FX rate is small in the Eurozone, this situation would nevertheless put pressure on the ECB to act earlier rather than later. Since the beginning of the year, long-term German benchmark yields have largely mirrored the upward movement in US yields. The "transatlantic spread" of 10-year maturities has remained largely stable (180bps). But instead of diverging term premia, the yield spread now relies on diverging short-term interest rate expectations.

Figure 11 : Eurozone – inflation decomposition (y/y, contributions in pp)



Sources: Refinitiv, Allianz Research

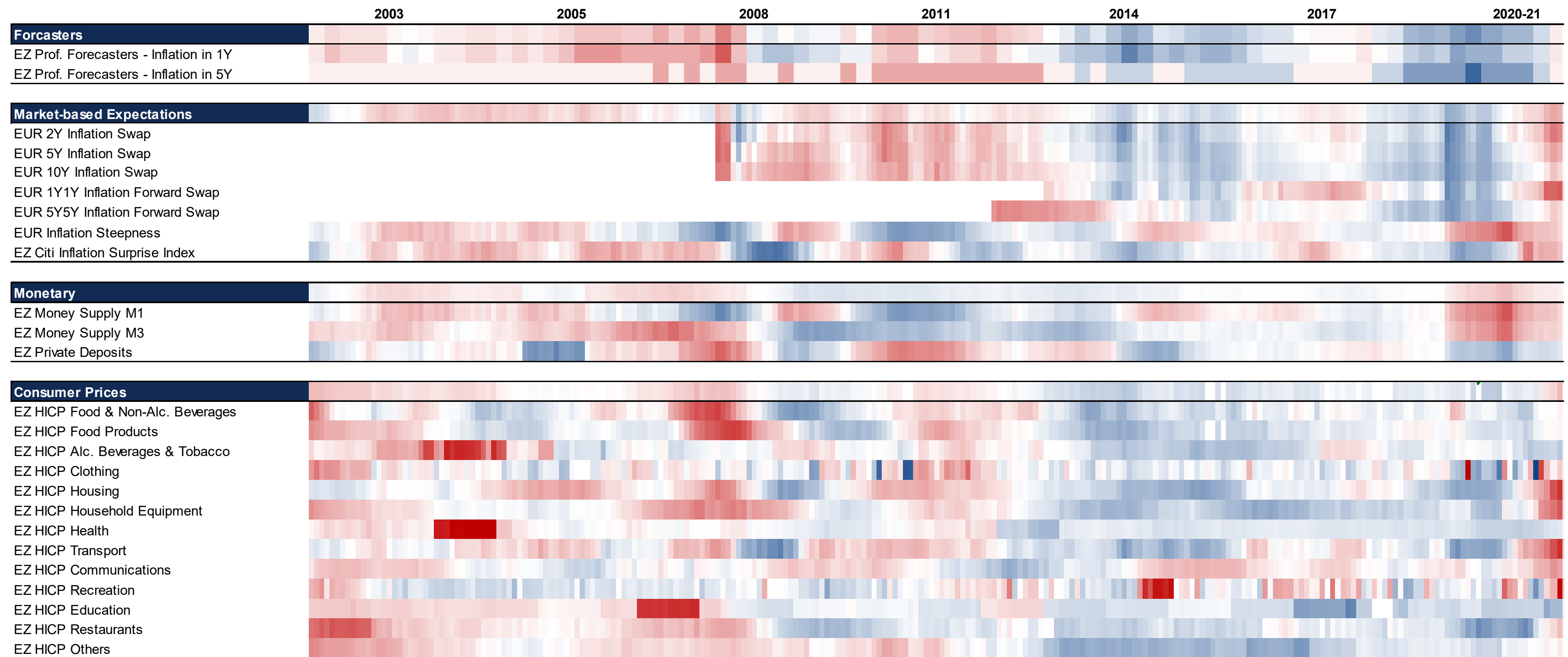
Turning more hawkish, however, is easier said than done. Pre-committing to a more dovish stance for 2022 at the December meeting has set the ECB up for major policy u-turn risk. There are no clearly marked emergency exit doors. Revising the current forward guidance would require a quite aggressive pivot of the current monetary stance. For instance, the exit sequence inherent in the ECB's forward guidance would require tapering to be completed in Q3 2022 to lay the groundwork for a rate hike in Q4 2022 (which is implied by current, super-charged market expectations). Moreover, the ECB might face the risk of growing dissent in the GC, as indicated by the accounts of the December policy meeting, which generally raises the bar for any policy shift.

Appendix: Allianz Inflation Tracker (composite measure of sub-indices and breakdown of "official measures" and "underlying inflation" sub-indices)

Sources: Refinitiv, Allianz Research

Note: Our composite measure of inflation ("Inflation Tracker") is an equally weighted and normalized measure comprising 15 sub-segments: underlying trends (modified/trimmed measures), forecasts, market-based inflation measures, expected inflation implied by term structure models, monetary aggregates, consumer and producer price components, labor market indicators, commodity prices, corporate margin & profitability, and proxies for price effect from supply chain disruptions). 1/ corporate profitability = equity forward 12-month earnings per share (EPS).

Appendix (continued): Allianz Inflation Tracker (breakdown of "forecasters", "market-based expectations", "monetary" and "consumer prices" sub-indices)



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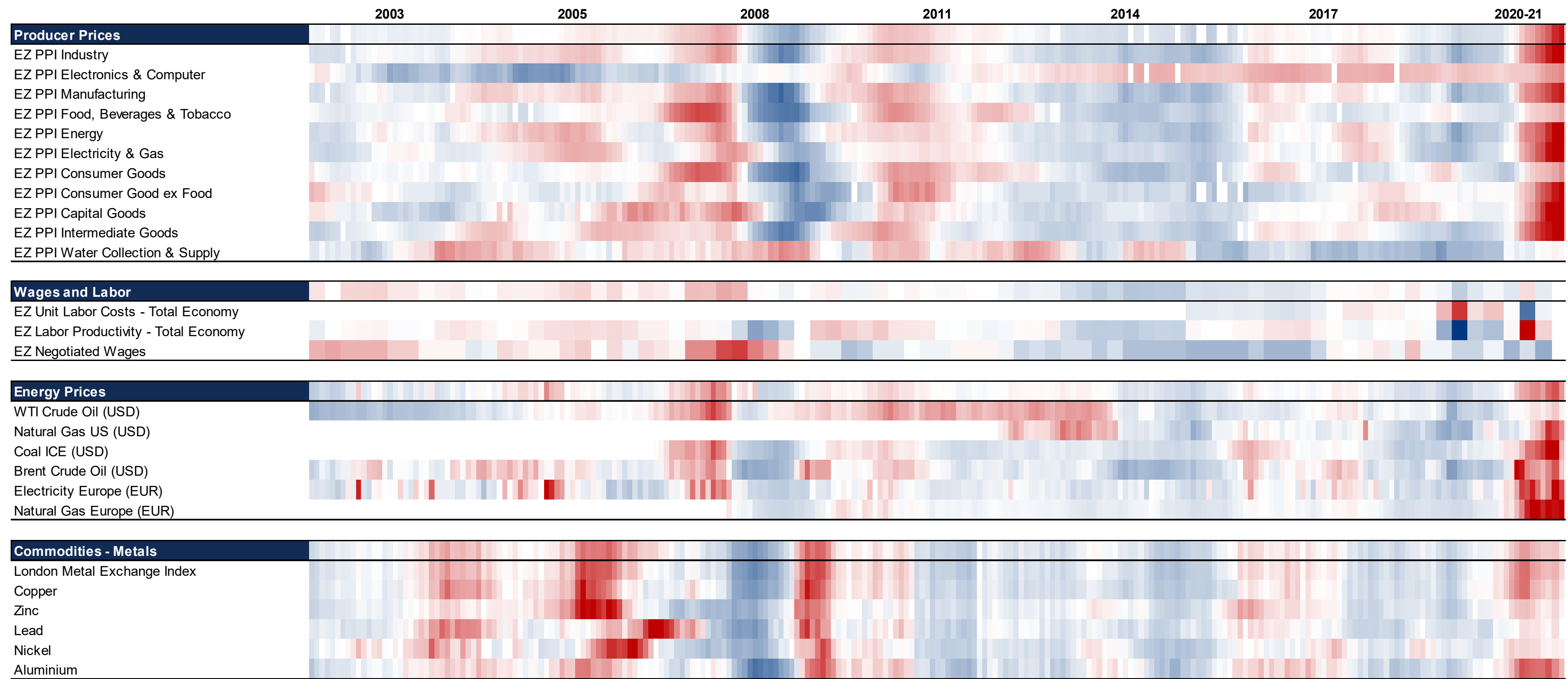

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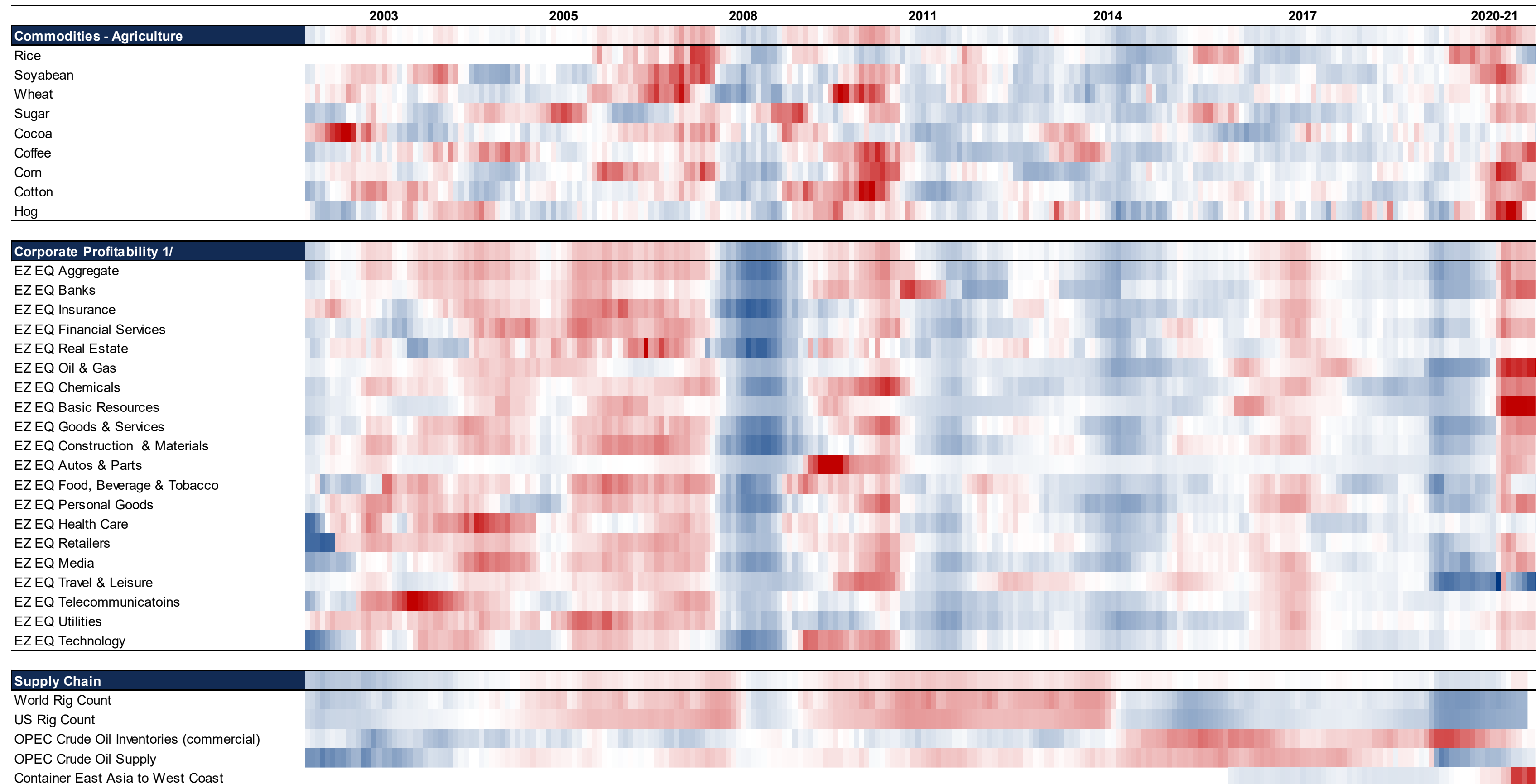

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