Economist's Weekly Market View

Tuesday, 26th April 2022

Lift-Off on ECB Rates Approaching

There has been a remarkable hardening of Eurozone interest rate futures contracts since early March. The initial view of markets was that the Russian invasion of Ukraine greatly reduced the likelihood of an ECB rate hike this year. However, markets have since done a complete somersault and now expect at least three 25bps rate hikes before the year is out, possibly starting as early as July. The three month futures contract for July has firmed by 25bps since early March.

Meanwhile, the December 2022 rates futures contract has hardened by 70bps, with the December 2023 futures moving by 130bps. So not only are markets now pricing in a minimum of three 25bps rate hikes for the second half of this year that would take the deposit rate from -0.5% to 0.25%, they are also looking for the ECB to continue raising rates by a further 125bps to 1.5% over the course of 2023.

The ECB decision in March to bring forward the end date for net asset purchases under its QE programme to the third quarter of 2022, with guidance that rate hikes could begin some time after, opened the door for policy tightening to begin this year. It has indicated that a decision on the exact timing for the conclusion of net asset purchases would be made at its June policy meeting.

There seems to be a growing consensus among the ECB Council members that asset purchases should end around mid-year. This means that the ECB Council meeting in late July could well deliver a rate hike, and this is now close to being fully priced in by the market. In this regard, the ECB has emphasised that in the current highly uncertain environment, it will maintain optionality, gradualism and flexibility in regard to the conduct of monetary policy.

Some ECB Council members are very open to the idea of a July hike. However, both the ECB President and Vice-President have indicated that rate increases will depend on incoming data and the ECB's evolving outlook for the economy and inflation. The ECB's next set of macro-economic projections, which are to be issued at the June Council meeting, will be crucial in this regard. In this regard, the flash PMI indices for April released last Friday were stronger than expected, suggesting that the economy may be proving more resilient than anticipated.

Overall, with inflation elevated, negative ECB interest rates look set to be consigned to the history books by end 2022. Further out, the latest IMF forecasts published this week, project a marked slowdown in growth in the Eurozone economy, with inflation also decelerating rapidly to an average rate of 2.3% next year and 1.8% in 2024 and 2025. This would not be consistent with a rate tightening cycle that extended to the end of next year, amounting to 200bps.

However, the IMF emphasised the considerable uncertainty around its projections, which it says is well beyond the usual range. It notes that inflation could turn out to be higher than expected, while central banks may need to adjust policy aggressively should CPI rates remain persistently elevated.

This chimes with the ECB view that it needs to maintain optionality and flexibility on monetary policy given the highly uncertain environment. For now though, with inflation running at 7.4%, the heat is increasing on the ECB to get moving on raising rates before too long.

Oliver Mangan

Chief Economist,
AIB

* *

AIB Customer Treasury Services
DUBLIN / CORK
aib.ie/fxcentre

Customer Treasury Services NI
BELFAST
aibni.co.uk/fxcentre

Customer Treasury Services GB
LONDON
aibgb.co.uk/fxcentre