Scotiabank

GLOBAL ECONOMICS

FLASH REPORT

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ECB's Lagarde Settles as Top Hawk; BoE Delivers 'Simple' Hike with Dovish Tinge

- **The ECB shifted to a lower pace of hikes today, announcing a 50bps increase as we, practically all economists, and markets were expecting in a categorically hawkish decision as Lagarde teed up a series of half-point hikes and the bank revealed more details than were expected on its balance sheet reduction plans.**
- **Lagarde signaled that the ECB could hike by 50bps at least two more times, saying that the half-point pace should be expected "for a period of time", adding that market pricing would not allow the bank to reach the 2% inflation goal.**
- **The Bank of England lifted its policy rate by 50bps this morning as was widely expected. Policymakers were split three ways. Only one member of the MPC voted in favour of a 75bps increase (Mann) and two voted for a rates pause.**
- **A depressed economic outlook, with the UK currently in recession, has not yet dissuaded the Bank from hiking aggressively as it attempts to tame steep inflation, but we think the rate hiking cycle is nearing an end.**
- **Some policymakers calling for no increase today supports this view, and we may see a few in the MPC switch to a vote in favour of 25bps in February.**

HAWKISH ECB: THE LADY IS NOT FOR SLOWING (AGAIN)

The ECB shifted to a lower pace of hikes today, announcing a 50bps increase as we, practically all economists, and markets were expecting (with a ~20% chance of a 75bps hike).

The EUR is a massive outperformer on a day where the USD is broadly stronger. A moderate 0.2% gain in the EUR against the dollar contrasts to a ~0.8% depreciation in the GBP and JPY.

EUR strength is accompanied by huge increases in European yields, with short-term yields (2y Bunds up 25–30bps) lifted by the hawkish near-term policy outlook while steep increases in long-term yields in the periphery follow QT plans (10y BTPs up 25–30bps).

The ECB decision was categorically hawkish as Lagarde teed up a series of half-point hikes and the bank revealed more details than were expected on its balance sheet reduction plans as well as presenting projections that still see core inflation near 2.5% in 2025. We had expected merely a teeing-up of a February QT announcement today, in a concession to hawks in the council that would have preferred a 75bps hike at this meeting.

Lagarde signaled that the ECB could hike by 50bps at least two more times, saying that the half-point pace should be expected "for a period of time", adding that market pricing would not allow the bank to reach the 2% inflation goal. Yesterday, markets were seeing a peak rate around 2.75%. Today, this peak stands around 3.25%—though pricing may be somewhat erratic at writing. This could still be below the terminal level that the ECB guided today. According to Lagarde, evidence today "predicates another 50bps hike at our next meeting and possibly at the one after that, and possibly thereafter, but everything will also be determined by the review of data.

The ECB intends to reduce its Asset Purchase Programme (APP) portfolio by an average EUR15bn per month between March and June 2023, with its subsequent pace "determined over time". This is a significantly smaller amount than an 'organic' roll-off of maturing assets as the ECB expected APP redemptions to total EUR42bn, EUR30bn, EUR36bn, and EUR23bn in March, April, May, and June 2023, respectively. There is also a massive estimated EUR52.7bn redemption in October 2023.

On paper, the EUR15bn may be seen as a conservative target in relation to expected redemptions, but that it was already laid out today is a hawkish development. Lagarde noted that the EUR15bn level was picked as that is roughly half of the average monthly redemption size from March–June. On average, this would also apply to the maturing amounts for the remainder of the year (meaning the average is also around EUR15bn), so the question is if the bank will increase this 'half' to 'two-thirds' or another higher fraction. This will be a key item to monitor in ECB speeches and comments in the months ahead.

Today's suite of communications suggest that the ECB could lift its policy rate as high as 3.25% or 3.50%. Markets are not biting, however, somewhat in line with the lukewarm reaction in Fed rates pricing to yesterday's hawkish message from Powell. There may be some disbelief in markets that central bankers will be able to continue rate increases (and hold rates higher for longer) in the face of contracting economies. **Lagarde is certainly ready to challenge that opinion.**

BOE HIKES 50BPS IN DIVIDED VOTE; SLIGHT CHANCE OF ADDITIONAL DOWNSHIFT IN FEB

The Bank of England lifted its policy rate by 50bps this morning as was widely expected. Policymakers were split three ways reflecting discord about the inflation outlook in the country and what impact policy tightening to-date and incoming hikes have had or will have on the domestic economy.

Only one member of the MPC voted in favour of a 75bps increase (Mann) **and two voted for a rates pause** (Dhingra and Tenreyro) **against the six-votes median at 50bps** (including hawk Haskel); **there were no votes for a quarter-point hike**. Thus, while the median settled on a 50bps increase, the February meeting is heading towards a closer decision between 25 or 50bps (markets had ~45bps cumulatively priced in between today's and February's decision).

The GBP is trading practically unchanged after a brief dip upon the release of the statement, falling below 1.23 against the USD and 1.16 against the EUR, while gilts are richer (prior to ECB-related moves, 2s and 10s were down 6bps and 2bps, respectively, from pre-statement levels) following the bank's announcement as markets had priced in a roughly 20% probability of a 75bps increase.

Wagers on a larger hike rose after stronger than expected labour and prices data released earlier this week, to later take a hit on soft inflation data for November published yesterday. Though on the employment side of the picture there are signs of cooling amid falling vacancies, and layoffs/attrition could eventually follow, prices data had generally not cooperated with the BoE's goals. Yesterday's print does not make a trend, however.

A depressed economic outlook, with the UK currently in recession, has not yet dissuaded the Bank from hiking aggressively as it attempts to tame steep inflation, but we think the rate hiking cycle is nearing an end. Some policymakers calling for no increase today supports this view, and we may see a few in the MPC switch to a vote in favour of 25bps in February.

The bank did not provide new projections, as this was done at its previous decision, but **the minutes of the meeting highlighted that the bank now sees a lower inflation path relative to the November projection**. This is due to a longer than expected energy subsidy on home energy bills. On the flip side, public spending reductions and tax increases show up later in their outlook as an economic drag that more than offsets the relative increase in one-year ahead GDP levels. There was no mention in the minutes that this longer energy price guarantee scheme would lead to higher core inflation relative to forecasts. This is important from the standpoint that the BoE seemingly does not see it impacting non-essential spending to a significant degree (always in comparison to previous projections) and thus lifting prices of these goods or services.

We maintain our call for another 50bps increase by the BoE in February followed by a final 25bps hike in March. As things stand, based on the latest data and today's decision, we see no convincing reason to alter this projection—and even the BoE notes that they have only received limited additional information since November. Stubbornly high inflation could see the BoE hike a touch more, although higher rates for longer looks the more likely path rather than eyeing, for instance, a 5% bank rate.

As for downside risks to our rate forecast, we think that on top of softer inflation prints in coming months, **the BoE would want to see more evidence of weakness in labour markets and on wages growth before choosing to pause** —though on wages, ongoing negotiations in unionized roles could fuel an important second-round impact.

Note that the BoE did not provide additional comments on QT plans with its sales schedule for Q1-2023 due at 18UK on December 16.