Bond Blog

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ECB in Pole Position to Over-Tighten in 2023

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A central narrative of 2022 was that central banks, including the European Central bank (ECB), were “behind the curve”. As a result, eurozone inflation rose to levels not seen for decades, eroding living standards. If this assessment was right, financial conditions would need to tighten significantly in 2023.

But does this critique of the ECB stand up to scrutiny? What would have been the alternative prescription? And what are the prospects for ECB monetary policy in 2023?

First, central banks that hiked earlier than the ECB haven’t necessarily experienced lower inflation (see Figure 1). For example, Czechia and the UK, countries with broadly comparable inflation levels to the eurozone’s in early 2021, began to increase interest rates six months to a year before the ECB raised its deposit facility rate out of negative territory. Yet, neither has experienced lower inflation than the eurozone.

FIGURE 1: Central Bank Interest Rate Hike Timing and Latest Inflation Outturns (%, annualized)

Source: Macrobond.

A second criticism is that the ECB over-relied on its economic models, which proved ineffective at predicting the current bout of inflation. In the summer of 2021, the ECB expected headline eurozone inflation of 1.4% in Q3 2022. But inflation came in at 9.3%, more than six times its projected level.

As Figure 2 shows, however, central bank models were not the only ones that fared poorly in their predictive power. Other forecasters - from professionals to consumers - also expected inflation to come in at or below the ECB’s 2% target. Their forecasts were no better than the ECB’s.

FIGURE 2: Table of Q3 2021 Forecasts of Eurozone Inflation in Q3 2022 (%)

Forecasters	1 year ahead inflation forecasts in September 2021
ECB	1.4
Professional forecasters	1.1
Market-based	2.2
Bloomberg consensus	1.3
Consumers	2.4
Outturn (Q3 2022)	**9.3**

Source: ECB, Bloomberg.

In addition, two events with important inflationary consequences occurred after the summer of 2021. Neither of these could have been known to central banks or, indeed, almost anyone.

First, heading into the winter of 2021-22, it was unclear if vaccines would be effective or if social distancing - with its economic consequences - would have to continue. Indeed, the emergence of the omicron variant in autumn 2021 seemed to warrant continued central bank support. But the mild nature of omicron infections and the effectiveness of vaccination programs led to a more robust demand recovery than initially expected.

The second significant string of events after the summer of 2021 was the shock to European energy prices and Russia's invasion of Ukraine. These events led to an unprecedented 40% rise in household energy prices. Now, energy makes up around 10% of households' consumption. So, the only way for overall headline inflation to remain at 2% in the third quarter of 2022 would have been for all other prices to fall by more than 2%.

This hypothetical decline of more than 2% compares to an all-time low in eurozone HICP[1] inflation, excluding energy, of 0.5%, during the acute phase of the pandemic. So the only way for the ECB to deliver 2% inflation amidst soaring energy prices would have been to engineer an economic collapse. Unsurprisingly, even the most ardent ECB critics have not advocated such a proposition.

In summary: the argument that central banks should have withdrawn support in the summer of 2021 assumes a level of foresight that belies the uncertainties and unknowns at the time.

But some say that the ECB should have purchased slightly fewer bonds, and that interest rates should have risen slightly earlier. That suggests a degree of precision that policymakers do not have in real time, especially not when faced with crises such as a global pandemic and the outbreak of war.

A decomposition of the "news" in inflation - i.e. the gap between what the ECB expected for inflation in Q3 of 2022 and the actual outturn - shows that unexpectedly higher energy prices and Covid-related supply chain distortions explain almost all of it.[2]

Other indicators, such as inflation expectations and nominal wages across the eurozone, corroborate this picture, as they remained at levels broadly consistent with the ECB's 2% inflation target. Stability in these other inflation gauges suggests that further interest rate hikes, beyond the ECB's normalisation to date, risk over-tightening financial conditions.

However, the ECB's latest policy meetings, in December and February, suggest that it intends to raise policy rates further, and start trimming its balance sheet in March. If the eurozone economy proves to be as resilient as the ECB expects, then its hawkish judgement may well prove to be correct.

But if, for example, the economic drag from the war in Ukraine is more substantial, that would put the ECB at the front of the queue among central banks at risk of overtightening in 2023. Looking at 2022 in retrospect suggests that the ECB need not be in catch-up mode: its pace of tightening was - and, based on the latest data, is - appropriate to curtail the inflation risks that it can control.

[1] The HICP (Harmonised Index of Consumer Prices) is an indicator of inflation and prices for the ECB.

2 See https://www.ecb.europa.eu/pub/economic-bulletin/focus/2022/html/ecb.ebbox202203_05~6d1fb8f5b0.en.html

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as 2/8/2023.

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