



The ECB's Hawkish Stance May Not Last Much Longer

Market events could prompt a softening of policy
this summer.

April 2023

What a difference six months can make. In the autumn, markets were anticipating a eurozone recession amid supply chain disruptions and a massive surge in gas prices. Yet by the turn of the year, growth was proving to be more resilient than expected on the back of falling gas prices and unseasonably warm weather. I believe the European Central Bank (ECB) will maintain its hawkish path for the time being, but I also believe that there are risks on the horizon that could lead to a marked softening in monetary policy from the summer onward. These moves in interest rate policy would have clear implications for our currency and bond exposure.

Aside from the mild winter and falling energy prices, another key contributor to the improvement in the eurozone economy has been the loosening of supply chains. During the pandemic, orders for German and other European manufactured products consistently exceeded production due to a shortage of key components, resulting in a significant backlog of orders. A surge in electronic equipment in February eased some of these supply chain constraints and will likely mean that European manufacturing output can continue to grow over the next few months even if demand starts to weaken.



Tomasz Wieladek
Chief European Economist

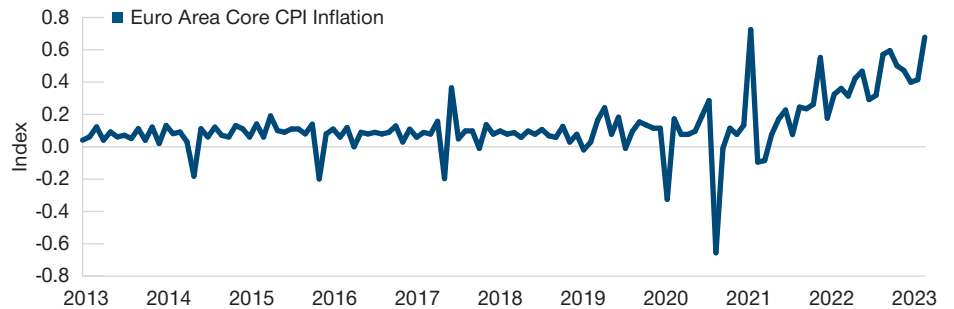
Inflation has been the most important influence on ECB policy and bond yields over the past year (Figure 1). The rise in energy and food prices directly contributed to a significant rise in headline Harmonized Index of Consumer Prices (HICP) inflation. However, higher eurozone energy prices also tend to raise core HICP inflation as businesses pass on the higher cost to their customers. This process has usually happened some months after the initial rise in energy prices and tends to last longer. Historically, this has meant that the peak in core HICP inflation has often arrived several months after the peak in headline HICP.

Indeed, the strength and momentum in the latest eurozone monthly core HICP inflation prints has surprised consensus forecasts significantly to the upside. Sticky core consumer price index (CPI) inflation at 5.5% and higher is now the most likely outcome until the summer, and core HICP inflation could reach 6% and higher in the coming months.

“Inflation has been
the most important
influence on
ECB policy....”

Inflation Is Driving ECB Policy

(Fig. 1) Core inflation has been rising over the past year



As of February 28, 2023.

Source: Statistical Office of the European Communities/Haver Analytics.

“
The ECB will therefore likely continue on its hawkish path in the near term....

Given the strong momentum in core HICP and resilient growth, the ECB is likely to remain hawkish and continue to tighten monetary policy for the next few months. This stance could be challenged if European banks become significantly affected by the U.S. banking crisis. The recent acquisition of Credit Suisse by UBS in Switzerland has raised concerns that other eurozone banks may suffer a similar fate, but in our view, the acquisition of Credit Suisse was likely due to idiosyncratic company-specific factors rather than industrywide ones. Eurozone banks are subject to a tougher regulatory regime than their U.S. counterparts because of a different implementation of Basel III rules, reducing the likelihood of contagion from Credit Suisse's collapse.

Where help is required, the ECB will likely use its financial stability directorate, rather than monetary policy, to address the problem. In this spirit, President Christine Lagarde emphasized at the March press conference that there is no trade-off between financial and price stability. The ECB will therefore likely continue on its hawkish path in the near term, with an estimated peak deposit rate of 3.75% and the ECB likely stopping all asset purchase programme (APP) reinvestment in the third quarter of 2023.

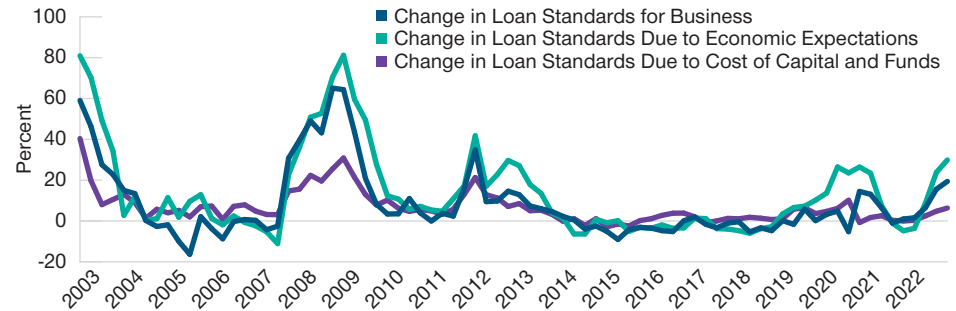
Indeed, our own analysis of the macroeconomic effects of recent shocks to the European and global banking system supports this view. Our proprietary econometric model suggests that shocks to perceived bank solvency up until March 29, if sustained for a whole month, would lead to a reduction in output of 0.6% in 18 months' time. However, this would only lead to a 0.25% reduction in core HICP inflation in two years' time. Even if the current banking system issues in the eurozone turn out to be persistent, they are not large enough to make a dent in the current core HICP inflation momentum in the bloc. Unless the current shock is the beginning of a much larger systemic banking crisis, our analysis therefore suggests that the ECB will need to continue hiking to control inflation in the eurozone.

There are, however, other risks on the horizon that could persuade the ECB to pivot away from its hawkish path toward the middle of the year. For example, while the mild winter helped Europe to avoid a potentially crippling gas shortage, the continent remains heavily reliant on liquefied natural gas (LNG), around 16% of which is imported from Russia. Global demand for LNG may increase significantly this year, largely as a result of China's reopening, potentially resulting in another gas price crisis.

“
There are...risks on the horizon that could persuade the ECB to pivot away from its hawkish path....

ECB Hawkishness Has Tightened Credit Conditions

(Fig. 2) Lenders are expecting a weaker economic outlook



As of December 31, 2022.

Source: European Central Bank.

A second risk is that the European banking system has hidden vulnerabilities, which will only crystallize when monetary policy continues to tighten. The European macrofinancial system is already under some strain because of rapid monetary policy tightening over the past six months (Figure 2). For households, credit conditions are already very tight. For firms, conditions have tightened but not nearly to the degree required to trigger a recession. Importantly, the tightening has been mostly due to lenders expecting a weaker economic outlook rather than rising funding costs, as in previous recessions. Further aggressive tightening or the emergence of a banking system vulnerability would

likely activate this second channel, tighten credit conditions, and lead to a recession.

Finally, if the current U.S. banking crisis leads to a U.S. recession, the eurozone would likely also enter a recession with a lag due to external demand weakness.

We believe it is likely that at least one of these scenarios will crystallize in the second half of the year, which may prompt the ECB to cut its deposit rate toward the end of 2023 or the beginning of 2024. We expect short-term bund yields (Schatz) to grind higher in the near term as the ECB continues to tighten monetary policy. As we enter the summer, we believe the risks mentioned above are more likely to materialize.

T. Rowe Price cautions that economic estimates and forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual outcomes could differ materially from those anticipated in estimates and forward-looking statements, and future results could differ materially from historical performance. The information presented herein is shown for illustrative, informational purposes only. Forecasts are based on subjective estimates about market environments that may never occur. The historical data used as a basis for this analysis are based on information gathered by T. Rowe Price and from third-party sources and have not been independently verified. Forward-looking statements speak only as of the date they are made, and T. Rowe Price assumes no duty to and does not undertake to update forward-looking statements.

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

T.RowePrice®

Important Information

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of April 2023 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates.

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only. International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. Fixed-income securities are subject to credit risk, liquidity risk, call risk, and interest-rate risk. As interest rates rise, bond prices generally fall.

T. Rowe Price Investment Services, Inc.

© 2023 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.