Goldman Sachs | Economics Research

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European Economics Analyst

ECB—More Urgency to Act (Radde/Stehn/Schnittker)

- Recent ECB commentary suggests that the Governing Council is very likely to end QE at its June meeting and guide towards lift-off at the July meeting, consistent with our forecast for a 25bp hike in July. The subsequent pace of hikes, however, remains subject to debate given slowing growth and stubbornly high inflation.
- The Euro area activity dataflow since the start of the war has been mixed, with robust services growth but very weak industrial activity. The outlook for the rest of the year remains soft given the incoming consumer drag from high energy prices, weaker trade and tighter financial conditions. We lower our area-wide forecast slightly further, pushing down our 2022 growth forecast by 0.1pp to 2.5% (vs 2.7% consensus) and reducing our 2023 projection by 0.2pp to 1.7% (vs 2.3% consensus). The key risk remains a large-scale disruption of Russian gas supply, which would push the Euro area into recession, with large contractions in Germany and Italy.
- At the same time, the incoming information implies yet more persistent inflationary pressures. First, our analysis points to more significant second-round effects from the surge in energy prices and we raise our wage growth projections to 2.8% this year and 3.6% in 2023. Second, we estimate that the weakness of the Euro will push up inflation moderately over the next couple of years. Third, the re-intensification of bottlenecks is likely to keep core inflation elevated for longer. Taken together, we raise our inflation forecasts and now expect area-wide core HICP inflation to remain at 2.2% at the end of 2023 (up from 1.8% before) and at 2.1% in 2024Q4.
- Our revised inflation path points to greater pressure on the Governing Council to tighten monetary policy rapidly despite weak growth. We therefore accelerate our ECB tightening forecast and now expect the Governing Council to hike 25bp at back-to-back meetings until June next year to a terminal rate of 1.5%. Compared to our previous forecast we now (1) accelerate the move towards neutral (from December to April 2023) and (2) add one extra hike that takes the monetary policy stance slightly into restrictive territory.
- Given the high uncertainty around the outlook, we consider a range of scenarios and map these into deposit rate paths using an estimated ECB reaction function. First, we find that the Governing Council would likely hike more quickly and

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move further into contractionary territory if second-round effects turn out to be stronger. Second, our analysis suggests that the emergence of sovereign stress—if unchecked through a backstop—could pause the hiking cycle. Third, a Russian gas ban, even when combined with a large negative confidence shock, would not necessarily delay lift-off, but would likely slow the hiking cycle and could require policy easing next year.

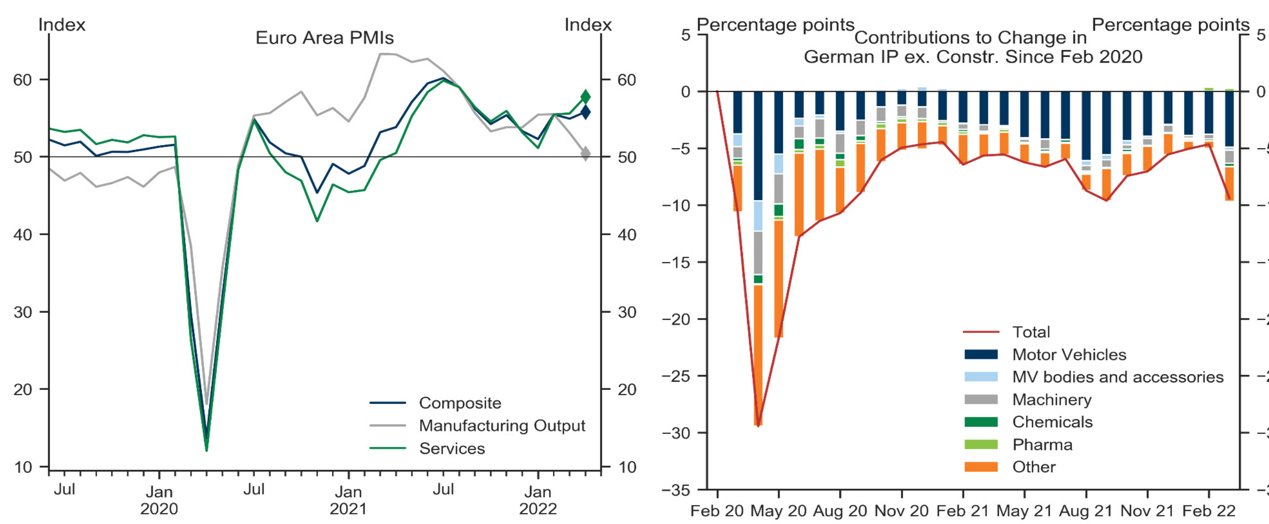
ECB—More Urgency to Act

Given high inflation, a weak Euro and rising concern about second-round inflation effects, the Governing Council is likely to end QE at its June meeting, signal that its inflation conditions for lift-off have been met and guide towards the first hike at the July meeting. ECB officials, however, face a difficult trade-off in setting the pace of policy rate increases. On the one hand, uncertainties around the war in Ukraine, the expected slowdown of consumption and the risk of sovereign stress as rates rise point to a gradual normalisation pace. On the other hand, stubbornly high headline inflation, the likelihood of second-round inflation effects and the very accommodative level of real rates calls for more urgency in the speed of tightening.

A Cautious Outlook for Activity

The Euro area activity dataflow since the start of the war has been mixed. Services activity held up better than expected in March and April—given a robust post-Omicron rebound—and we look for strong tourism activity in the summer months, especially in the South (Exhibit 1, left). But manufacturing activity has slowed sharply, especially in Germany, reflecting weak auto production in March, a sharp drop in trade with Russia and renewed Covid restrictions in China (Exhibit 1, right). On balance, we maintain our Q2 real GDP tracking estimate of 0.2% (non-annualised).

Exhibit 1: Mixed Momentum into Q2

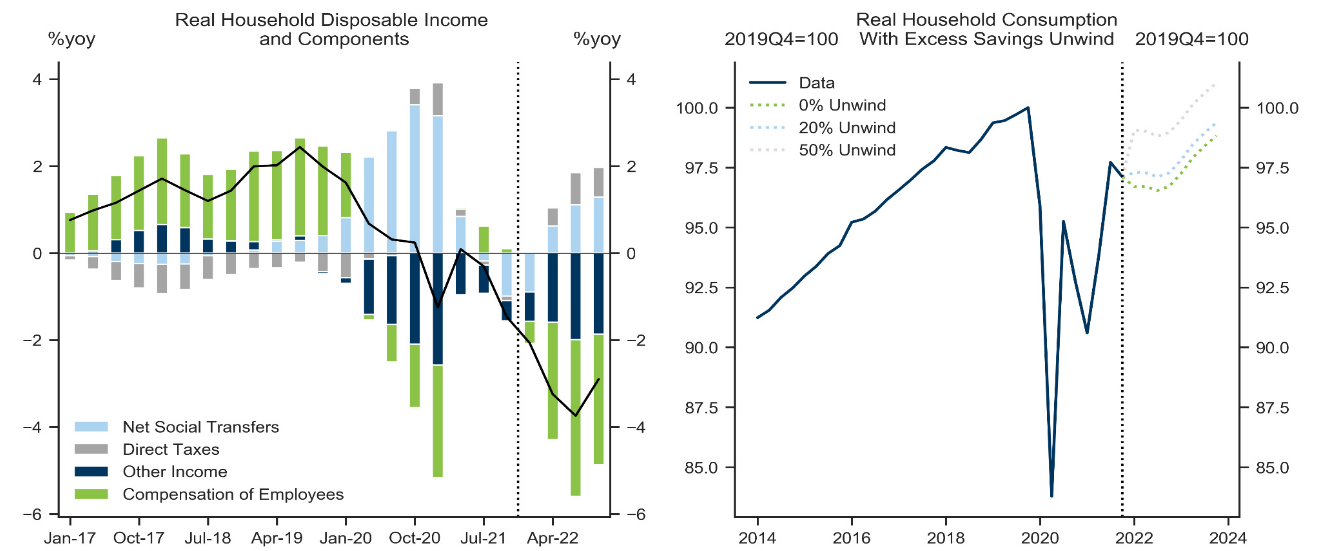


Source: Goldman Sachs Global Investment Research, Markit, Haver Analytics

For the rest of the year, we anticipate weak Euro area growth given the likelihood of a large drag on consumer spending from high energy prices for consumers, weaker trade and tighter financial conditions.

First, we expect weak consumption growth this year due to squeezed real incomes. Despite generous government support to households and accelerated nominal wage growth from 2022H2, both real wages and other real income will contract substantially in 2022 (Exhibit 2, left). While we expect some unwind of excess savings that were accumulated during the pandemic to cushion this drag over 2022-23, we look for roughly flat consumption in Q4/Q4 terms this year (Exhibit 2, right).

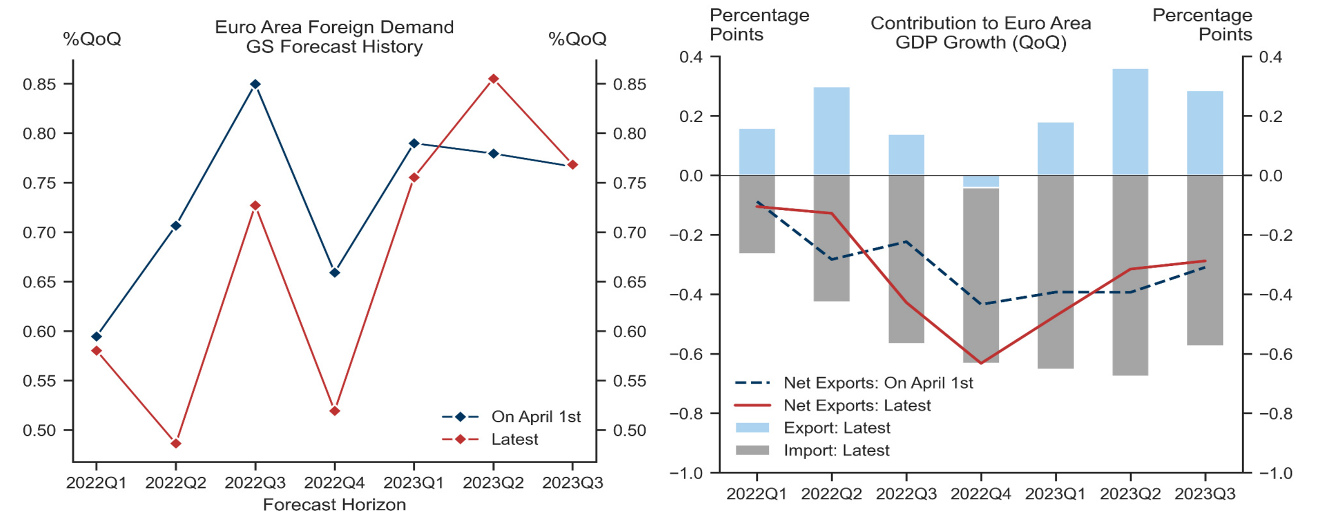
Exhibit 2: Consumer Hit in the Pipeline



Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, the outlook for foreign demand has weakened further as growth has slowed abroad (Exhibit 3). Following very weak April data, we recently downgraded our growth expectations for China, and now expect 4% growth this year (vs 4.5% previously). Also, we downgraded our 2022 and 2023 US growth forecasts to 1.25% and 1.5% (both on a Q4/Q4 basis), respectively, in response to the sharp tightening in US financial conditions. While the recent depreciation of the Euro will provide some cushion, our Euro area trade model points to an additional growth drag in coming quarters through lower net exports.

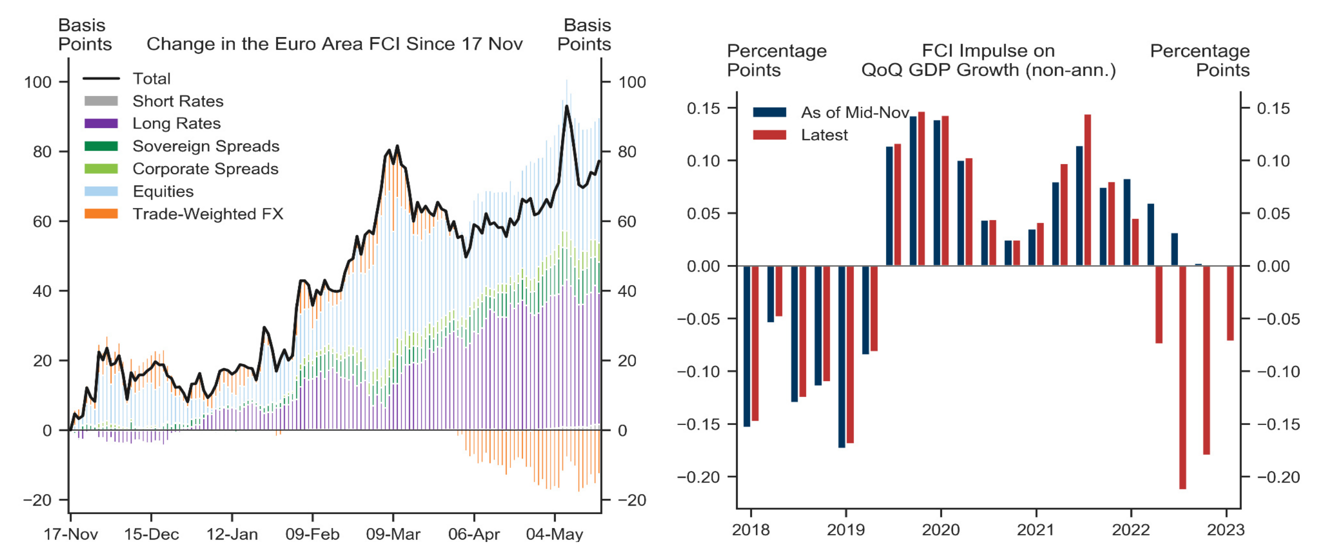
Exhibit 3: A Stronger Headwind from Abroad



Source: Goldman Sachs Global Investment Research, Haver Analytics

Third, financial conditions have continued to tighten in recent weeks and our FCI now stands about 80bp tighter than the mid-November low. While the Euro has weakened notably on a trade-weighted basis, our overall FCI has tightened significantly given higher long-term rates, lower equities and wider sovereign and credit spreads (Exhibit 4, left). Our FCI growth impulse—the estimated effect of financial conditions on growth—has therefore turned notably negative since the start of the year.

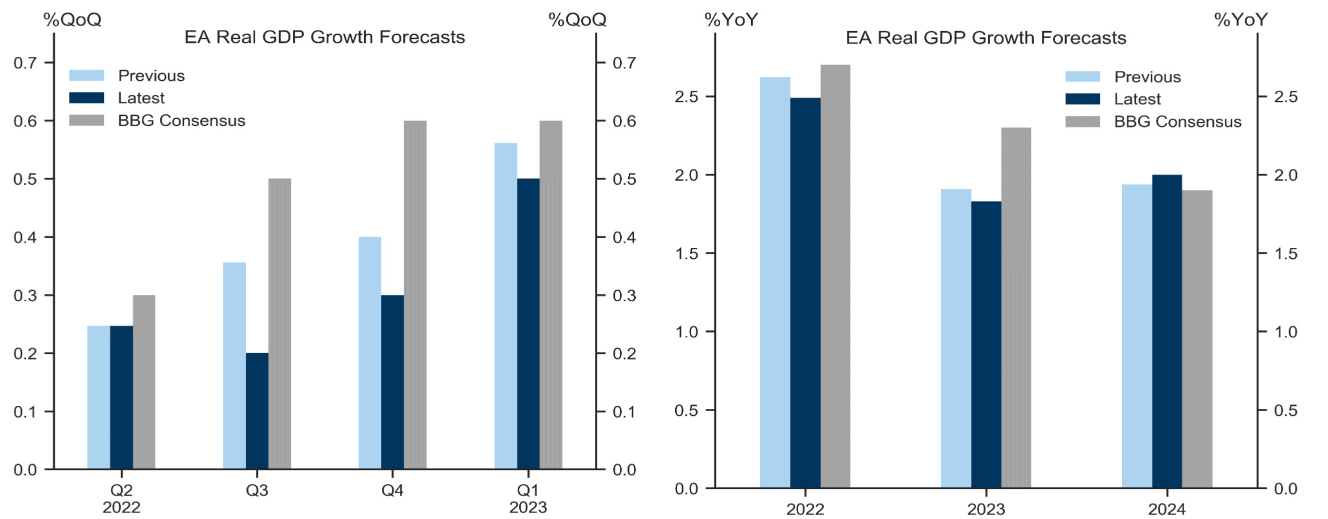
Exhibit 4: A Growing Drag From Tighter Financial Conditions



Source: Goldman Sachs Global Investment Research

We therefore lower the Euro area growth outlook slightly further, reinforcing our below-consensus growth view for the Euro area (Exhibit 5). More specifically, we lower Q3, Q4 and Q1 by a tenth each, to 0.2%, 0.3% and 0.5%, respectively. This pushes down our 2022 growth forecast to 2.5% (vs 2.7% consensus) and our 2023 projection to 1.7% (vs 2.3% consensus).

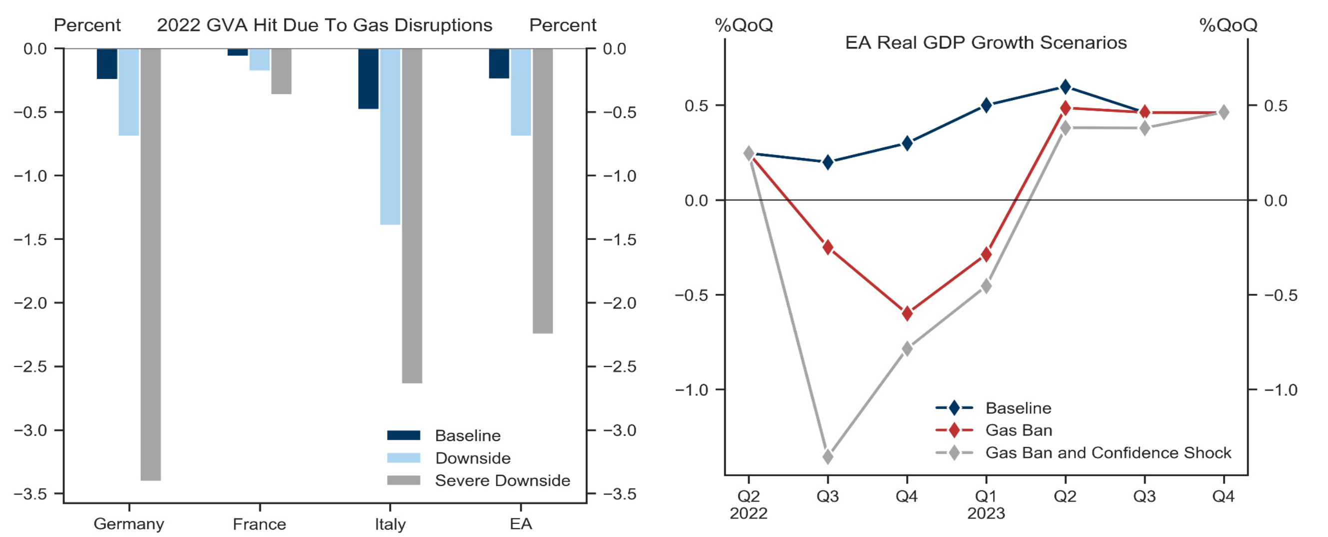
Exhibit 5: A Cautious Growth Outlook



Source: Goldman Sachs Global Investment Research, Bloomberg

While we do not look for a recession in our baseline forecast given fiscal support and strong household balance sheets, the key risk remains a large-scale disruption of Russian gas supply. Our baseline assumes that Russian gas flows continue largely uninterrupted, but we estimate that a complete gas ban would lower Euro area growth by 2.2pp this year, pushing the Euro area into recession (Exhibit 6). Our analysis suggests that a gas ban would imply particularly large hits to Germany (-3.4pp) and Italy (-2.5pp). We see further downside risks from a negative confidence shock to consumer spending, effectively layering an aggregate demand shock on top of an aggregate supply shock.

Exhibit 6: Paths to Recession



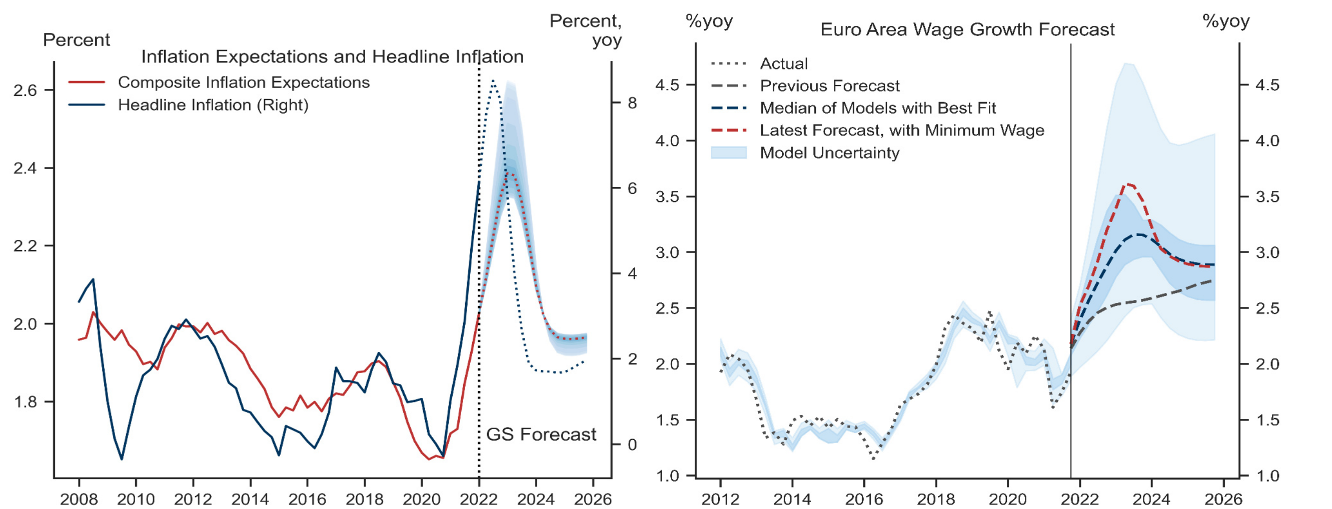
Source: Goldman Sachs Global Investment Research

More Embedded Inflation

At the same time, the incoming information implies yet more persistent inflationary pressures.

First, our recent analysis points to more significant second-round effects from the surge in energy prices. In particular, we find that energy price shocks have historically pushed up long-term inflation expectations quite persistently and lifted wage growth notably for 1-2 years. Inflation expectations have already moved up and now stand slightly above the ECB's target, but high headline inflation is likely to push long-term inflation expectations up further in coming months (Exhibit 7, left). While spot wage growth remains around 2%, we revise up our wage growth forecast given continued labour market improvement, the likelihood of second-round effects from high headline inflation and news of higher union wage demands. In particular, our model now points to wage growth of 3% by year-end (vs 2.5% before) and 3.3% by the end of 2023 (vs 2.75% before). Combined with the minimum wage increases in Germany, we now look for annual wage growth of 2.8%, 3.6% and 3% in 2022, 2023 and 2024, respectively.

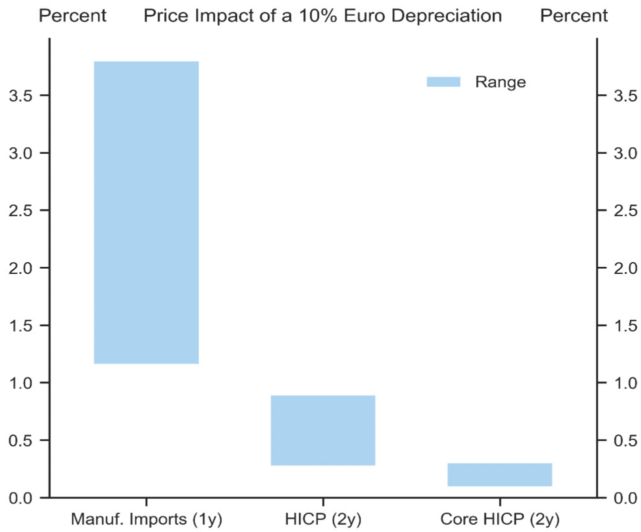
Exhibit 7: Second-Round Effects to Come

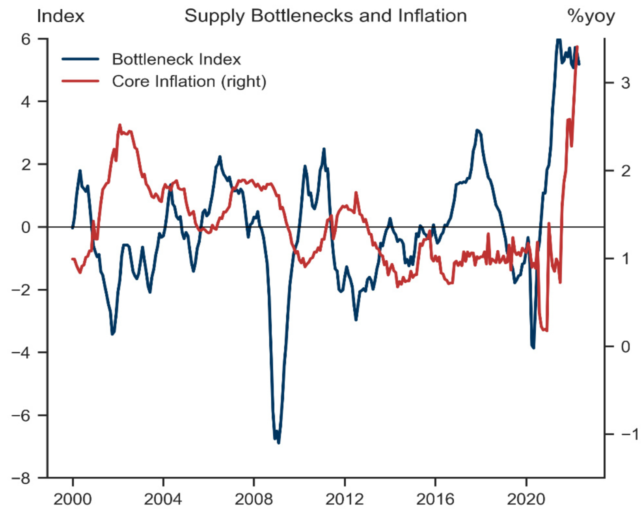


Source: Goldman Sachs Global Investment Research, Haver Analytics

Second, we estimate that the weakness of the Euro will push up inflation over the next couple of years. Our analysis suggests that a 10% trade-weighted Euro depreciation lifts the level of consumer prices by somewhat less than 1% after two years (Exhibit 8, left). Should Euro weakness persist, it would add 0.15-0.5pp to annual headline inflation in each of the next two years, and about one third as much to core inflation. Consistent with this, a number of ECB speakers have recently flagged that the weakness of the Euro will have a significant effect on the June ECB staff projections.

Exhibit 8: A Slower Decline in Goods Inflation



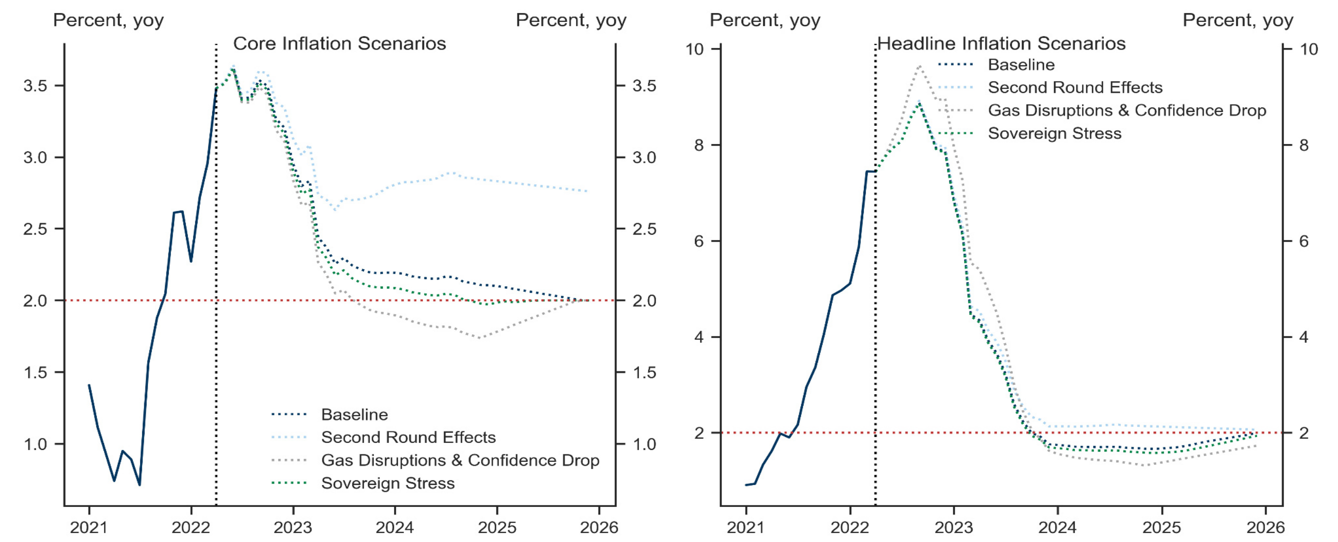


Source: Goldman Sachs Global Investment Research, Haver Analytics

Third, the re-intensification and broadening of bottlenecks is likely to keep core inflation elevated for longer than we had anticipated. While supply-demand imbalances in the manufacturing sector appear to be easing, labour shortages and broader input costs pressures continue to weigh on supply. We summarise these pressures in a bottleneck index, which has led Euro area core inflation quite tightly by about a year since the start of the pandemic (Exhibit 8, right).

Taken together, we therefore raise our core inflation profile notably for the next couple of years (Exhibit 9). We now expect area-wide core HICP inflation to remain at 2.2% at the end of 2023 (up from 1.8% before) and at 2.1% in 2024Q4. Our updated projections thus maintain the view that the Euro area has a more limited inflation problem compared to the US, where we expect core CPI inflation to run at 2.7% at the end of 2023. However, our updated projections now suggest that core inflation will remain above the ECB's target through 2024.

Exhibit 9: Yet More Inflation Persistence



Source: Goldman Sachs Global Investment Research, Haver Analytics

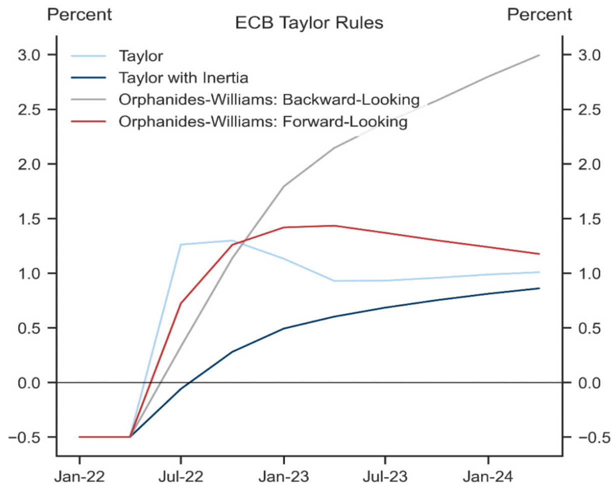
That said, the inflation outlook remains unusually uncertain with risks skewed towards more inflation persistence. In particular, we calculate that a Russian gas ban would lift headline inflation by an additional percentage point to a peak of about 10%. Moreover, we estimate that stronger second-round effects—captured by the upper bound on the wage growth projections in Exhibit 7—would keep core inflation around 2.5% in 2024.

A Faster Pace

Our revised inflation path points to greater pressure on the Governing Council to accelerate monetary policy normalisation despite weak growth. To quantify this, we update our estimated ECB reaction function, which relates changes in the deposit rate to growth (vs potential) and inflation pressures (vs target).[1] Although simple, this version of the Taylor rule has historically captured the Governing Council's decisions fairly well and points to a rapid rise in the deposit rate to about 1.5% in early 2023 (Exhibit 10, left). Given the uncertainty around the ECB's reaction function, we compare this rule to other candidate specifications, which points to a range of outcomes in both directions.

[1] We regress changes in the Deposit Facility Rate on a constant—which captures the ECB's implicit inflation aim—inflation expectations three quarters ahead as recorded in the ECB's Survey of Professional Forecasters (SPF) as well as the change in a slack measure. Our estimated coefficients are 0.57 on expected inflation and 0.49 on slack, similar to a rule estimated by Orphanides and Wieland (2003).

Exhibit 10: Rising Urgency to Act



Date	Speaker	Comment
May 17	Knot	"Based on current knowledge, my preference would be to raise our policy rate by a quarter of a percentage point — unless new incoming data in the next few months suggests that inflation is broadening further or accumulating. If that is the case, bigger increases must not be excluded either. In that case a logical next step would amount [to] half a percentage point."
May 11	Schnabel	And as risks are growing that current high inflation is becoming entrenched in expectations, the urgency for monetary policy to take action to protect price stability has increased in recent weeks.
May 11	Lagarde	Judging by the incoming data, my expectation is that [asset purchases] should be concluded early in the third quarter. The first rate hike...will take place some time after the end of net asset purchases...this could mean a period of only a few weeks. After the first rate hike, the normalisation process will be gradual.
May 6	Villeroy	Barring unforeseen new shocks, I would think it reasonable to have entered positive territory by the end of this year.

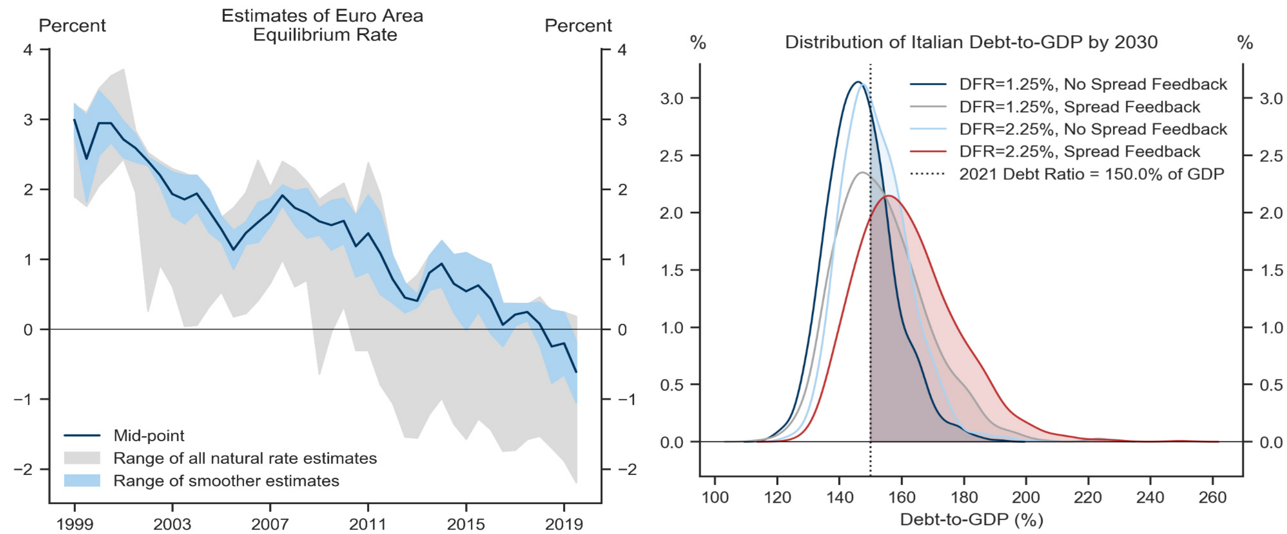
Source: Goldman Sachs Global Investment Research, ECB

Although a helpful starting point, this exercise abstracts from a number of considerations that will be important in shaping the Governing Council's exit path in practice.

First, it matters whether slower growth reflects weaker demand or supply. Economic principles suggest that the ECB should respond to the firmer inflation outlook by moving policy rates to a more normal setting despite softer growth if weaker activity primarily reflects supply. Moreover, our analysis suggests that the Governing Council should hike more quickly and move into restrictive territory if significant second-round effects emerge, but tighten more cautiously if confidence effects weaken demand, despite the high inflation numbers. Given our view that (1) the majority of the slowdown in growth reflects weaker supply and (2) some second-round effects are likely to emerge, these considerations support recent ECB calls for a more rapid pace of tightening (Exhibit 10, right).

Second, the assessment of what constitutes a neutral policy setting is a key driver of the speed of tightening. Estimates of the equilibrium rate (or r*) are highly uncertain in the Euro area, as reflected in recent ECB staff estimates (Exhibit 11, left). That said, these estimates cluster around -0.75%, pointing to a nominal neutral rate of around 1.25%.

Exhibit 11: Neutral vs Risk Management



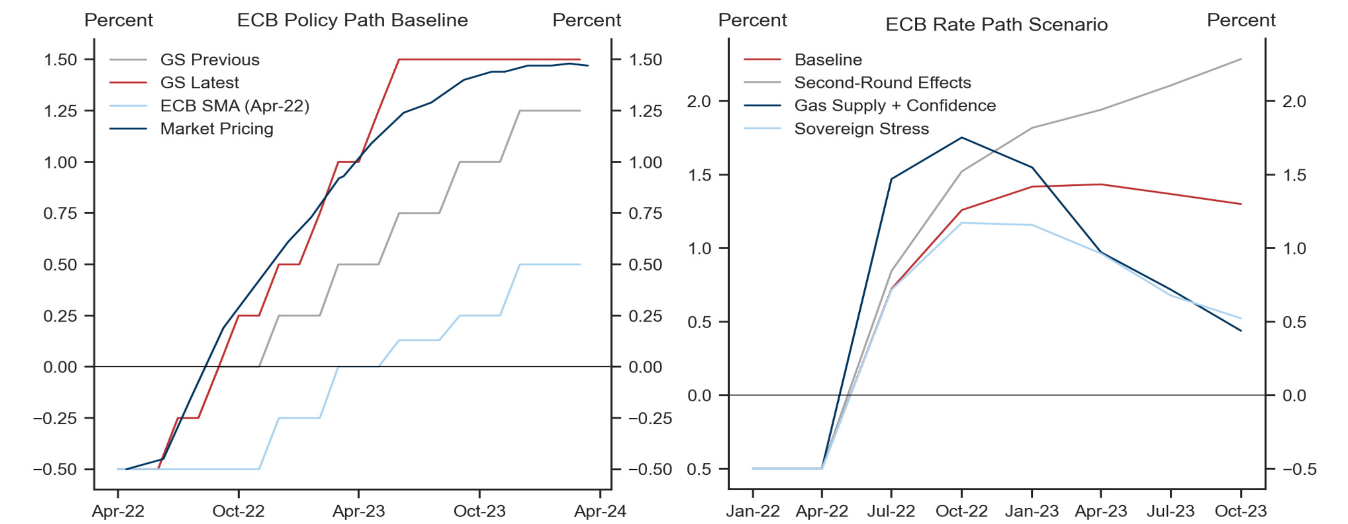
Source: ECB, Goldman Sachs Global Investment Research

Third, risk management is an important consideration for the pace of rate rises, given remaining vulnerabilities in the Euro area. In particular, the Governing Council is guiding towards a "gradual pace" of normalisation, signalling to move carefully in light of elevated uncertainty around the economic outlook. ECB officials are particularly attentive to the risk of renewed sovereign stress, pledging to avoid fragmentation risk. While our debt sustainability analysis suggests that a gradual hiking path to 1.25% should be manageable for Italy's fiscal outlook, the risk of fiscal stress could rise materially with a terminal rate above 2% (Exhibit 11, right). We believe that ECB officials would activate a sovereign backstop in this case, including capital key deviations and some form of conditionality.

Quicker and Restrictive

Taken together, we therefore see greater urgency to act and accelerate our ECB tightening forecast (Exhibit 12). We maintain our forecast that the Governing Council will end APP at the end of June and raise the deposit rate for the first time by 25bp in July. But we now expect the Governing Council to hike 25bp at back-to-back meetings until June next year. Compared to our previous forecast we now (1) accelerate the move towards neutral (from December to April 2023) and (2) add one extra hike that takes the monetary policy stance slightly into restrictive territory.

Exhibit 12: A More Rapid Pace



The baseline rate path shown in the right-hand side exhibit is derived from an estimated Taylor rule and is hence different from our baseline rate forecast.

Source: Goldman Sachs Global Investment Research, ECB

Given the high uncertainty around the economic outlook, we consider the scenarios for growth and inflation discussed above, and map these into deposit rate paths using our estimated reaction function above (Exhibit 12, right).

First, we find that the Governing Council would hike more quickly and move further into contractionary territory with stronger second-round effects. With more elevated and persistent core inflation, we would expect the Governing Council to consider 50bp steps, taking the deposit rate to a peak of around 2.5%. Second, our analysis suggests that the emergence of sovereign stress – if unchecked through a backstop – could delay the hiking cycle. In practice, we think the ECB would likely trigger its sovereign yield backstop if the widening of sovereign yields was driven by speculation rather than fundamentals or an external shock. Third, a Russian gas ban, even when combined with a large negative confidence shock would not necessarily delay lift-off, but would likely slow the hiking cycle after strong initial tightening and could require policy easing next year. Although stylised, these scenarios help capture the uncertainty around our faster tightening baseline.

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Disclosure Appendix

Reg AC

We, Sven Jari Stehn, Steffan Ball, Alain Durre, Soeren Radde, Christian Schnittker, Filippo Taddei and Ibrahim Quadri, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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