Europe: ECB tapers on expected lines but BoE delivers a surprise rate hike

- The European Central Bank (ECB) stuck to the script by confirming that the Pandemic Emergency Purchases Program (PEPP) would end by March 2022 but will remain an option if required in the future. The ECB also increased the size of its traditional Asset Purchase Program (APP) over Q22022 and Q32022. Overall it confirmed that monetary policy would remain accommodative.
- However, the hawkish surprise from the ECB came from the upward revisions that were made to the inflation projections for 2021-24. We still believe that rate hikes are unlikely and balance sheet expansion is likely to continue in 2022 but that is less clear for H22023 and 2024.
- In contrast to the ECB, the Bank of England’s (BoE) MPC surprised markets by announcing a rate hike of 15bps by a 8-1 vote. The main reason behind the hike was the step-up in inflation concerns and the fact that labour market conditions had not deteriorated. We see the BoE hiking rates by 50 bps in 2022 and prospect of quantitative tightening from Q42022/Q12023 onwards.
- Both central banks acknowledged the uncertainty that Omicron poses for the outlook. However, both central banks noted that the net adverse effect of each subsequent wave of the virus on GDP has been diminishing. Instead, focus for each central bank was on the inflation outlook. Hence, the new variant did not influence policy decision making.
- The hawkish surprises by both the ECB and BoE could provide near-term support for the EUR/USD and GBP/USD pairs respectively. Going in to 2022, we see divergence in performance. The EUR/USD pair could get weighed down by monetary divergence while the GBP/USD pair could have a flatter trajectory.

ECB: delivers a taper, keeps policy accommodative but raises inflation projections: The ECB policy meeting came largely in line with expectations. The central bank announced that the pace of asset purchases will slow in 2022 but provided a slightly more hawkish message on inflation. Key takeaways from the policy meeting are as follows:

- **PEPP: will end on schedule but remains an option to use if required:** In line with expectations, the ECB indicated that the pace of purchases under PEPP would slow further from Q12022 onwards. PEPP will also end on schedule by March 2022. However, the reinvestment of maturing securities under PEPP was extended to at least till the end of 2024 and that future roll-off will not interfere with the monetary policy stance. PEPP could also resume at a later point in time if required. Reinvestments would also include Greek bonds that are not eligible under the traditional APP. The ECB retained some degree of flexibility in terms of possible decisions that it might take on PEPP that will remain contingent on the manner in which the pandemic, financial conditions and the economy evolves.

- **APP: size was increased temporarily:** To ensure smooth functioning of the market, the ECB decided to increase the size of the open-ended monthly APP program from EUR 20bn to EUR 40bn in Q22022 and to EUR 30bn in Q32022. This was done to compensate for the end of purchases under PEPP. From October 2022, the size will revert back to EUR 20bn per month.

- **Policy rate guidance unchanged:** The ECB retained its forward guidance of keeping policy rates at current levels until inflation stabilizes over the medium-term at 2%.

- **Growth: Lower in 2022 but still constructive:** The ECB indicated that a short-term hit to growth is likely from the new variant and subsequent lockdowns that have been imposed to curtail the spread. Hence, Q42021 and Q12022 growth forecasts were lowered. Some concerns from supply-side disruptions effecting activity were also expressed but these disruptions were expected to fade later in 2022 and in to 2023. Hence, growth projections for 2023 were revised higher. Overall, risks to the outlook were described as balanced. The central bank also took note of the fact that the incremental negative impact on growth from each subsequent wave of infections has been lower as the households/business have learned how to live and adjust to the pandemic.

- **Inflation projections revised higher:** The most notable development was the sharp upward revisions that were made to the inflation projections. The ECB raised its CPI inflation projections from 2.2% YoY to 2.6% for 2021 and from 1.7% to 3.2% in 2022 reflecting supply-side disruptions, normalization of tax rates in Germany and energy price trends. For 2023, CPI inflation was raised from 1.5% YoY to 1.8% and was expected to remain at 1.8% in 2024. Hence, the threshold for raising interest rates takes place only if inflation averages 2% over the forecast horizon and is expected to remain above the 2% mark by the end of the forecast horizon. Forecasts suggest conditions for rate hike don’t seem to have been met yet. However, the scale of upward revisions made implies that the central bank sees a higher inflation trajectory in the medium-term. The ECB President Lagarde also emphasized that ‘inflation could turn out to be higher’.

Shivom Chakravarti
shivom.chakravart@icicibank.com
Phone number: 022-4008-6273

Please see important disclaimer at the end of this report
**Outlook:** Overall, we think that the actions taken were largely in line with expectations. However, the upward revisions in inflation projections warrant careful attention as it shows that the central bank is much more concerned about price pressures than compared to the previous policy meeting.

We think that the ECB will follow through with the guidance provided keeping policy accommodative and continuing with its balance sheet expansion in to 2022. We do not see rate hikes over 2022. We think that growth concerns from another wave will dominate commentary and decision making over H12022. However, we continue to watch for guidance on inflation over the 2023-24 period.

We remain constructive on the outlook of the Euro-zone as pent-up demand could increase once lockdowns/restrictions ease and given that fiscal policy is expected to remain expansionary. However, underlying inflation pressures such as wages have not accelerated sharply. Hence, at this stage any change in monetary stance or guidance seems unlikely.

---

**BoE delivers an unexpected hike on the back of inflation concerns:** After the unexpected hold in November, the BoE yet again surprised the market by delivering a 0.15% hike in the bank rate to 0.25% reflecting near and medium-term inflation concerns. The MPC voted 8-1 for such an action. The decision to hike rates has come just as the central bank concluded its QE program on 15 December 2021 showing that there was no lag between ending QE and embarking on a rate hiking cycle. Guidance provided was that ‘more modest monetary tightening’ could be on the cards going in to 2022. The key takeaways from the policy outcome are as follows:

- **Labour market conditions remain solid:** A key reason for the BoE to hold back on hiking policy rates in November can be attributed to concerns that the expiry of the job retention scheme in September would have on the labour market. However, early evidence would suggest that UK labour market remains fairly strong and the unemployment rate could continue to drift lower in the medium-term. The upshot is that concerns about the labour market dwindled quite sharply.

- **Inflation risks have increased:** Inflation concerns remained the dominant theme in the post policy statement and minutes of the meeting. CPI inflation has already increased from 3.1% YoY in September-2021 to 5.1% in November and is expected to peak at the 6% mark by April-2022. At the same time, wage prices are showing signs of firming up and supply-side disruptions could linger for longer that might add to the inflationary environment. At the same time, concerns were expressed about the impact that the current trend of inflation could have on ‘inflationary expectations’ in the economy. Hence, there was an urgent need at the current juncture to move forward and tighten policy given the firm mandate of ensuring price stability that the MPC has.

- **Omicron is a risk but is difficult to assess at this stage:** The MPC members expressed concerns about the ‘Omicron’ variant of the virus and the effect that it could have on the economy. However, the MPC took note of the fact that the incremental hit to GDP for successive waves has fallen. Hence, it remains unclear at this stage as to the overall effect that the new variant would have in terms of curbing economic activity on a sustained basis. MPC members also believed that the new variant might disrupt supply-chains driving global inflation rates higher and in that manner de-anchor inflationary expectations. Even though GDP growth projections were lowered for Q42021 and Q12022, it was not enough for the MPC to hold back tightening policy.
Outlook: We see scope for an additional 50 bps worth of rate hikes by the BoE over the course of 2022. It remains unclear as to whether this will come as early as in the February meeting. We suspect that if Omicron dampens economic activity and plays a prominent role in keeping mobility in check in Q1 2022, the BoE might opt to hike rates later in 2022 than in Q1 2022. We also think that the BoE could consider resorting to quantitative tightening by allowing maturing securities to roll-off its balance sheet sometime from Q4 2022 or Q1 2023.

Market impact: Both the ECB and BoE provided a hawkish surprise. From the ECB, markets had to adjust to a higher inflation trajectory forecasted over 2021-24 period and only a temporary increase in size of purchases under the APP. From the BoE, investors were surprised by the rate hike that was delivered as inflation concerns were given greater weight than the ongoing concerns about the new variant of the virus. Hence, both the EUR and GBP have rallied against the USD. In the near-term, we would see possible upside of 1.1350-1.1400 for the EUR/USD pair and 1.34 for the GBP/USD pair.

Going into 2022, we see divergence in EUR/USD and GBP/USD performance.

The EUR/USD will likely get weighed down by monetary divergence as the FOMC ends QE and begins a rate hiking regime while the ECB maintains its accommodative framework as balance sheet expansion is likely to continue over 2022. We see the EUR/USD pair moving to the 1.10 mark by Q2 2022.

In contrast, we see some upside in the GBP/USD pair reflecting the BoE embarking on its own monetary tightening cycle. We see a flat trajectory for the pair. We see the GBP/USD pair trading in the 1.34-1.36 range by Q2 2022.
Economics Research Group

Economics Research

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sameer Narang</td>
<td>Head of Economics Research</td>
<td>(+91-22) 4008-1414 (ext. 6220)</td>
</tr>
<tr>
<td>Shivom Chakravarti</td>
<td>Economist—Global Markets</td>
<td>(+91-22) 4008-1414 (ext. 6273)</td>
</tr>
<tr>
<td>Dr. Sudarshan</td>
<td>Economist—India Markets</td>
<td>(+91-22) 4008-1414 (ext. 6708)</td>
</tr>
<tr>
<td>Bhattacharjee</td>
<td></td>
<td><a href="mailto:sudarshan.bhattacharjee@icicibank.com">sudarshan.bhattacharjee@icicibank.com</a></td>
</tr>
<tr>
<td>Debomitra Sen</td>
<td>Research Analyst</td>
<td>(+91-22) 4008-1414 (ext. 8161)</td>
</tr>
<tr>
<td>Aniket Gaikwad</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 8161)</td>
</tr>
<tr>
<td>Kaushal Aryan</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7249)</td>
</tr>
<tr>
<td>Asha Sasikumar</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7249)</td>
</tr>
<tr>
<td>Sarbartho Mukherjee</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7249)</td>
</tr>
<tr>
<td>Jyoti Sharma</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7249)</td>
</tr>
<tr>
<td>Tanisha Ladha</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7309)</td>
</tr>
<tr>
<td>Nihal Kumar</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7309)</td>
</tr>
<tr>
<td>Aditya Sharma</td>
<td>Research Analyst</td>
<td>(+91-22) 2653-1414 (ext. 7309)</td>
</tr>
</tbody>
</table>

Treasury Desks

<table>
<thead>
<tr>
<th>Desk</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gsec Desk</td>
<td>(+91-22) 2653-1001-05</td>
</tr>
<tr>
<td>FX Derivatives</td>
<td>(+91-22) 2653-8941-43</td>
</tr>
<tr>
<td>Commodities Desk</td>
<td>(+91-22) 2653-1037-42</td>
</tr>
</tbody>
</table>

Disclaimer

This document is issued solely by ICICI Bank Limited ("ICICI Bank") Any information in this email should not be construed as an offer, invitation, solicitation, solution or advice of any kind to buy or sell any securities, financial products or services offered by ICICI Bank or any other entity, unless specifically stated so. The contents of this document do not take into account your personal circumstances. Before entering into any transaction, you should take steps to ensure that you understand the transaction and have made an independent assessment of the appropriateness of the transaction in light of your own objectives and circumstances, including the possible risks and benefits of entering into such transaction and should seek your own financial, business, legal, tax and other advice regarding the appropriateness of investing in any securities. ICICI Bank (including its branches, affiliates of ICICI Bank) do not provide any financial advice, and is not your fiduciary or agent, in relation to the securities or any proposed transaction with you unless otherwise expressly agreed by us in writing.

The information, opinions and material in this document (i) are derived from sources that ICICI Bank believes to be reliable but the reliability or accuracy of which have not been independently verified (ii) are given as part of ICICI Bank's internal research activity and not as manager of or adviser in relation to any assets or investments and no consideration has been given to the particular needs of any recipient; and (iii) may contain forward looking statements, which may be materially affected by various risk, uncertainties and other factors. The opinions contained in such material constitute the judgment of ICICI Bank in relation to the matters which are the subject of such material as at the date of its publication, all of which are expressed without any responsibility on ICICI Bank's part and are subject to change without notice. ICICI Bank has no duty to update this document, the opinions, factual or analytical data contained herein. ICICI Bank and/or its affiliates makes no representation as to the accuracy, completeness or reliability of any information contained herein or otherwise provided and hereby disclaim any liability with regard to the same. The recipient of the information should take necessary steps as they deem necessary prior to placing reliance upon it. Nothing contained in this publication shall constitute or be deemed to constitute an offer to sell/purchase or as an invitation or solicitation to do so for any securities or financial products/instruments of any entity.

This document is intended solely for customers of ICICI Bank and may contain proprietary, confidential or legally privileged information. No part of this report may be copied, disseminated or redistributed by any recipient for any purpose without ICICI Bank’s prior written consent. If the reader of this message is not the intended recipient and has received this transmission in error, please immediately notify ICICI Bank,
Please also note that ICICI Bank (including its branches, and affiliates) is unable to exercise control or ensure or guarantee the integrity of/over the contents of the information contained in e-mail transmissions and / or attachments and that any views expressed in this e-mail and / or attachments are not endorsed by/binding on ICICI Bank. Before opening any attachments please check them for viruses and defects and please note that ICICI Bank accepts no liability or responsibility for any damage caused by any virus that may be transmitted by this email and/ or attachments thereto.

DISCLAIMER FOR DUBAI INTERNATIONAL FINANCIAL CENTRE (“DIFC”) CLIENTS:
This marketing material is distributed by ICICI Bank Limited., Dubai International Financial Centre (DIFC) Branch, a category 1 Authorized Firm and regulated by the Dubai Financial Services Authority. This marketing material is intended to be issued, distributed and/or offered to a limited number of investors who qualify as 'Professional Clients' pursuant to Rule 2.3.3 of the DFSA Conduct of Business Rulebook, or where applicable a Market Counterparty only, and should not be referred to or relied upon by Retail Clients and must not be relied upon by any person other than the original recipients and/or reproduced or used for any other purpose.

DISCLOSURE FOR RESIDENTS IN THE UNITED ARAB EMIRATES (“UAE”):
Investors should note that any products mentioned in this document, any offering material related thereto and any interests therein have not been approved or licensed by the UAE Central Bank or by any other relevant licensing authority in the UAE, and they do not constitute a public offer of products in the UAE in accordance with the Commercial Companies Law, Federal Law No. 8 of 1984 (as amended) or otherwise.

DISCLOSURE FOR RESIDENTS IN HONGKONG
This document has been issued by ICICI Bank Limited in the conduct of its Hong Kong regulated business (i.e. type 1 license) for the information of its institutional and professional investor (as defined by Securities and Future Ordinance (Chapter 571 of Laws of Hong Kong) (the “SFO”)) customers; it is not intended for and should not be distributed to retail or individual investors in Hong Kong. Any person who is not a relevant person should not act or rely on this document or any of its contents. This document has not been reviewed, authorized or approved by any regulatory authority.

ICICI Bank and/or its affiliates are full service financial institutions engaged in various activities which may include securities trading, commercial and investment banking, financial advice, investment management, principal investment, hedging, financing and brokerage activities. As a result, you should be aware that a conflict of interest may exist. In accordance with the regulatory requirements and its own conflicts of interest policies, ICICI Bank has in place arrangements, internal policies and procedures to manage conflicts of interest that arise between itself and its clients and between its different clients. Where it does not consider that the arrangements under its conflicts of interest policies are sufficient to manage a particular conflict, it will inform you of the nature of the conflict so that you can decide how to proceed.

DISCLOSURE FOR RESIDENTS IN SINGAPORE
ICICI Bank Limited, India (“ICICI India”) is incorporated under the laws of India and is regulated by the Reserve Bank of India. ICICI Bank Limited, Singapore branch (“ICICI”) is regulated by the Monetary Authority of Singapore.

As mentioned, ICICI India is regulated by the Reserve Bank of India. Hence, in relation to your dealing with ICICI India, you understand that your interest will be subject to protection of local laws and regulations in India, which may offer different or diminished protection than available under Singapore laws and regulations. You also understand that the Monetary Authority of Singapore will be unable to compel the enforcement of the rules of the local regulators.

For more detailed disclaimer, please visit https://www.icicibank.com/disclaimer/disclaimertnc.html