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Q&A with Mark Wall

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In a new 'Q&A with' Mark Wall, Chief Economist, Europe shares his views on an immediate threat of contraction in Europe, how soon ECB will hike rates and how far ECB rates will rise.

Q: Global financial markets are worrying about recession, but is there an immediate threat of contraction in Europe?

A: Rising energy costs are a heavy burden for Europe and the Ukraine war has caused economic uncertainty to jump almost as much as during the global financial crisis. Our recession model puts the probability of contraction over the next 3-6 months as high as 50%, though this may overstate the true risks. The jump in uncertainty could dissipate if domestic resilience holds – as well it might. About half the cost to households has been covered by targeted measures such as energy price freezes and tax cuts. What concerns us most in 2022 is if Russian energy supply to the EU is severely disrupted, though we do not expect that. On recession, we are concerned headwinds from ECB and Fed monetary policy in 2023 could bring growth to a standstill next year. Easy fiscal policy may help Europe avoid recession, but it's a close call.

Q: How soon will the ECB hike rates?

A: There's an increasing sense the ECB is behind the curve on inflation, and the exit from QE and negative rates are approaching. We expect the ECB to stop buying bonds at the end of June and start hiking rates in July. We expect policy rates to be back to zero by the end of Q3 and into positive rates – for the first time in over 8 years – by the end of the year. The question is whether the ECB will hike in 0.25% or 0.50% increments. Our expectation is 0.25% but given the risk inflation remains higher for longer – we think consensus is being too complacent about how high inflation is likely to remain – the probability of the ECB opting for larger hikes is going up.

Q: How far will ECB rates rise?

A: Given concerns about inflation, we believe the ECB will hike policy rates from mid-2022 to mid-2023. Over this period, we expect 2.5 percentage points of interest rate hikes, raising the ECB deposit from -0.5% to +2.0%. This won't be easy for parts of the economy. Savers will benefit but borrowers will feel the strain. Firms may be more exposed than households. High debt sovereign bond markets could be tested too. But the ECB has anticipated this stress. It has indicated a willingness to intervene in bond markets to maintain



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financial stability and ensure policy rates can rise to deliver the ECB's primary objective of price stability.



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