ECB: A dovish pause now, a peak soon

A clearly more cautious European Central Bank increasingly seems to embrace the idea that the peak in policy rates has already been reached

After 10 consecutive hikes, the ECB's decision to leave policy rates unchanged should have been an easy one. The deposit rate remains at 4% and the ECB has increased rates by a total of 450bp since July last year. Comments by ECB President Christine Lagarde during the press conference didn't give away any new insights into how the central bank plans to proceed with its bond portfolio or banks' minimum reserves. Instead, Lagarde sounded more cautious on economic developments and stressed the 'higher for longer' principle a bit more than at the September meeting.

Since the start of the year, the ECB has been more optimistic regarding the eurozone's growth outlook than many other observers. At today's meeting, Lagarde sounded more cautious than in previous meetings, referring to the latest disappointing macro data and tentative signs of a weakening of the labour market. Sentences like "the [eurozone] economy should strengthen over the coming years" are much less optimistic than for example the ECB's September forecasts which had eurozone GDP growth returning to potential growth already in the first quarter of next year. Lagarde referred to a further unfolding of the monetary policy transmission over the coming quarters, making a significant downward revision to the ECB's staff projections at the December meeting very likely.

Regarding inflation, the ECB didn't change its view, seeing underlying inflation declining further and expecting measures of longer-term inflation expectations mostly around the 2% level. The impact of a new oil price shock seems to be less straightforward than expected.

The economic situation in the eurozone is deteriorating more and more quickly than the ECB had anticipated. The rise in bond yields since the September meeting has strengthened the impact of the ECB's tightening efforts so far. At the same time, however, the events in Israel and Gaza as well as the roller coaster ride of oil prices has reminded everyone about the uncertainty and imprecision of inflation forecasts. If in doubt, cut it out is not only a golden rule for editors but also an often-practised principle of central bankers. If in doubt, just pause.

No news on non-interest rate tools

Interestingly, the ECB did not provide any new insights in the discussion regarding the Eurosystem's bond portfolio and reserve requirements for banks. As much as there seems to have been a growing consensus to stop the reinvestments under the Pandemic Emergency Purchase Programme (PEPP) earlier than the official "at least until the end of 2024", the latest fiscal policy and market developments show how difficult such a decision could still be. Lagarde said that the ECB today had not even discussed the topic of its bond portfolio. The discussion on banks' minimum reserves has gained some traction recently but we expect it to be addressed in full only when the ECB presents the outcome of its review of the operational framework, probably in the spring of next year. During the press conference, Lagarde tried to play down this topic, mentioning that it was not a monetary policy instrument.

A pause now, a peak soon

After the September meeting, many ECB officials didn't like the market interpretation of a dovish pause and therefore kept the door to further rate hikes wide open. If anything, today's meeting actually further established the concept of a dovish pause. The ECB has never been more worried about the growth outlook and relatively relaxed about potential new inflation waves, stemming from oil prices. As a result, unless the eurozone economy miraculously rebounds in the coming weeks, we expect today's dovish pause to eventually be seen as the end of the hiking cycle.

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