ECB hikes by 50bp and drops forward guidance, while keeping the door open to more hikes

The ECB continues to fight against inflation and seems unperturbed by the market turmoil of the last few days. Dropping forward guidance, lowering inflation projections, and a growing awareness that the tightening so far can have adverse effects all suggest that today's meeting probably marks the final phase of ECB tightening

European Central Bank President Christine Lagarde at today's press conference

In light of the latest financial market developments, there were doubts about whether the European Central Bank would continue its hiking cycle today. But it has. As we expected, the ECB didn't want to risk damaging its inflation-fighting credibility and delivered the pre-announced 50bp rate hike. The ECB did not give any forward guidance on rates. The reaction to current financial market turmoil was to reference a resilient European banking sector and to stress that the ECB stood ready to "respond as necessary".

New staff projections point to dropping inflation

The big caveat when looking at the ECB's newest round of macro forecasts is that the cut-off date was two weeks ago. So, the latest market turmoil has not been factored in. Still, these forecasts reveal some interesting insights. Both headline and core inflation are expected to come down significantly over the next years, reaching 2.1% for headline and 2.2% for core in 2025. Still, the ECB calls inflation too high for too long.

With regards to growth, the ECB remains in our view slightly too optimistic with an upward revision of its growth forecast for this year to 1% and further strengthening to 1.6% in 2024 and 2025. Even though the ECB mentions the tightening of monetary policy as a reason for a slight downward revision of growth in 2024 and 2025. However, we think that the latest market developments are another reminder of the fact that the most aggressive monetary policy tightening since the start of the monetary union will have only marginal effects on the eurozone economy. The ECB's view that eurozone growth will return to a trend of 0.4% quarter-on-quarter from 2024 onward looks optimistic.

No longer an unconditional lender of last resort

Today's decisions illustrate that the ECB is no longer the unconditional lender of last resort for the eurozone. Since the financial crisis in 2007 and 2008, financial markets have gotten used to the idea that central banks will always play the lender of last resort. In a European context, be it a financial crisis, a euro crisis or a pandemic, the ECB has always been there to help. "Whatever it takes", if needed.

However, the big difference between the last 15 years and now is that there is a severe inflation problem. The ECB cannot simply return to its role of firefighter as it has to fight inflation. The fact that balancing between financial stability and price stability can be quite a conflict of interest for the ECB has already been clear since European bank supervision, in the wake of the euro crisis, was moved to the ECB. ECB President Christine Lagarde said several times during the press conference that there wasn't any trade-off between monetary policy and financial stability and that the ECB would tackle both separately with separate instruments.

Today's meeting could mark the start of the final phase of monetary policy tightening

What markets and central bankers are currently experiencing is actually what undergraduate students learn at college in their first year of studying economics: monetary policy has an impact on the economy. It shouldn't be a surprise to anyone that the most aggressive monetary policy tightening since the start of the eurozone in 1999 has and will have adverse effects. The last few days have been a good reminder to the ECB that the next steps in fighting inflation will be much harder than the steps taken so far. The first phase of exiting the so-called unconventional measures (negative interest rates and bond purchases) went relatively smoothly, but now that interest rates are in restrictive territory, every additional rate hike increases the risk of breaking something.

Lagarde today tried to convey the message that the ECB was not yet done with hiking interest rates, saying that there was still "a lot more ground to cover". However, Lagarde also said that this applied to the current base case scenario, which in fact is already outdated with the latest market woes. The fact that the ECB also (rightly) refrained from presenting any new forward guidance and stressed data dependency shows that the peak in interest rates might be nearer than many think. Today, the ECB didn't blink in light of the recent market turmoil. The next hours and days will show whether the ECB can stick to this stance.

All in all, today's decision and communication leave the door open to heated debates at the next meetings. It should be clear that with any further rate hike the risk that something breaks increases. Therefore, today's decisions could mark the start of the final phase of the ECB's tightening cycle: a slowdown in the pace, size and number of any further rate hikes. We stick to our view that the ECB will hike two more times by 25bp each before the summer and then move to a longer wait-and-see stance.

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