ECB hikes rates and isn't done yet

The press conference after the rate hike announcement showed that the European Central Bank (ECB) is determined to continue hiking interest rates. However, while today's jumbo hike was a no-brainer, we expect much more controversial discussions in December and an end to the hiking cycle in February next year

ECB President Christine Lagarde at today's press conference

The ECB has hiked interest rates by 75bp, bringing the deposit facility interest rate to 1.5% and the main refinancing rate to 2%. Contrary to the rate hike decisions in July and September, the size of today's rate hike seems to have been uncontested and broadly supported by all ECB members. Alongside the expected rate hike, the ECB also announced changes to the current Targeted-Long-Term-Refinancing Operations (TLTRO), in terms of the applied interest rate and earlier repayment dates. The central bank also decided to set the remuneration of minimum reserves at the ECB's deposit facility rate.

Regarding the changed TLTRO terms, from 23 November 2022 onwards, the interest rate on all remaining TLTRO III operations will be indexed to the average applicable key ECB interest rates. There will also be three additional moments for earlier repayments. According to the ECB, "it is necessary to adapt certain parameters of TLTRO III to reinforce the transmission of our policy rates to bank lending conditions so that TLTRO III contributes to the transmission of the monetary policy stance", which is a bit strange as the latest Bank Lending Survey had already signalled a tightening of lending conditions.

As regards the decision to set the remuneration of minimum reserves at the ECB's deposit rate and no longer at the refi rate, this should hardly have an impact as minimum reserves are currently only a fraction of overall excess liquidity. The ECB did not announce any reverse tiering.

The sharpest and biggest rate hike cycle ever

The ECB has now hiked interest rates by a total of 200bp over a period of slightly more than three months. It's the sharpest and most aggressive hiking cycle ever. In the previous two hiking cycles since the start of the monetary union, it took the ECB at least 18 months to hike rates by a total of 200bp.

Today's rate hike provides further evidence of the extreme paradigm change at the ECB. A year ago, ECB president Christine Lagarde said at a press conference that “the lady is not tapering”. Now, the ECB has conducted the most aggressive rate hikes in its history, despite a war in Europe, little signs of an overheating economy but rather indications of a looming recession, and record high inflation, which is mainly driven by high energy and commodity prices. A couple of years ago, the same ECB but different main characters might have decided differently. The current ECB, however, has woken up very late to the fact that even if inflation is driven by supply-side factors, too high inflation for too long can damage a central bank's credibility and plant the seeds for unwarranted second-round effects.

At the current juncture of a looming recession and high uncertainty, normalising monetary policy is one thing but moving into restrictive territory is another. With today's rate hike, the ECB has come very close to the point at which normal could become restrictive. However, during the press conference, Lagarde said that the ECB might still have to hike rates at several more meetings as the job to bring inflation back to target is not done yet.

First opening for a dovish pivot in December

Looking ahead, the ECB seems determined to continue hiking interest rates, though no longer at the current jumbo size of 75bp. Lagarde tried to give the impression that there will be more than one more rate hike. However, her comments about the fact that the ECB no longer believes in any estimates of a neutral interest rate, after previous comments that the central bank no longer believed in its inflation projections, make it hard to identify the ECB's precise reaction function. This reaction function can probably be summarised as 'whatever, whenever'. Lagarde also mentioned the word “recession” and stressed that incoming data and the next staff projections at the December meeting would be important. A first opening for a dovish pivot at the December meeting

We think that the debate at the December meeting will already be much more controversial than today, delivering another 50bp rate hike. However, as the ECB's inflation outlook for 2024 was already at 2.3% in September and will very likely be at 2% for 2025 at the December meeting, it is hard to see how the ECB can deliver more than an additional 75bp rate hikes. For us, the terminal rate remains at 2.25% for the deposit rate. The ECB has been too late and too slow with normalising monetary policy. It shouldn't try to make up for it by being too high for too long.

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