ECB minutes highlight growth concerns and wider differences at the last meeting

The just-released minutes of the ECB's September meeting reflect a more heated debate on inflation and the policy rate. A pause at the next meeting looks like a done deal but a rate hike in December remains a possibility.

When reading today's minutes of the ECB's September meeting one should not forget that, before being released, these minutes go through a long process of editing at the ECB and at national central banks. Therefore it cannot always be excluded that some messages are put in a slightly different light, already trying to prepare markets for the next meeting. Recall that the initial market reaction to the ECB's September decision was dovish. We also had the initial impression that the September hike and the dovish communication was actually marking the end of the ECB's hiking cycle. With oil price developments since then the risk, however, has increased that the ECB's job is not done yet.

More tension at the September meeting

Below are the most relevant parts from the just released minutes. The debate was indeed more heated than before, with views on inflation and the policy rate diverging more and some members having been in favour of a pause. “A solid majority of members expressed support for the 25 basis point rate hike.”

- ***The ECB has become more concerned about growth.*** "It was widely felt that, with hindsight, the June projections had been too optimistic about the strength of the economic recovery in 2023…Looking ahead, optimism about a rebound in private consumption embodied in the baseline beyond 2023 might be questioned, given a prolonged deceleration in annual credit growth."
- ***If anything, risks to inflation are still to the upside.*** "…members assessed that there were still upside risks to inflation due to potential renewed upward pressures on the costs of energy and food. Adverse weather conditions, and the unfolding climate crisis more broadly, could push food prices up by more than expected."
- ***The September rate hike could have been the last one.*** As "a range of model-based simulations suggested that a deposit facility rate in the region of 3.75% to 4.00%, so long as it was understood as being maintained for a sufficiently long duration, should be consistent with a return of inflation to target within the projection horizon."

Recent developments have put the ECB in an even more difficult position

As much as the ECB has tried to keep the door to further rate hikes open since the September decision, recent developments have clearly complicated its position. While the surge in oil prices will put new upward pressure on inflation and could make reaching the 2% target at the end of 2025 more unlikely, the conflict in Israel and the Middle East as well as the rally in bond yields will further dampen eurozone growth prospects.

The ECB's September staff projections were based on the technical assumption of an average oil price of $82/bbl in 2024. If oil prices were to average $95/bbl next year, this would probably push up the ECB's inflation forecasts to 3.3% for 2024 (from 3.2%) and more importantly to 2.4% in 2025 (from 2.1%). As a result, the return to 2% would be delayed to 2026.

Needless to say, any further escalation of the situation in Israel and the Middle-East, plus chances that terror could also reach Europe, would weigh on sentiment and growth. At the same time, the recent surge in bond yields could do what the policy rate hikes have not entirely achieved, yet - bringing down the demand side of the eurozone economy. Also, the surge in bond yields, combined with new debt sustainability concerns in the eurozone, will make it harder for the ECB to eventually agree on an apparently envisaged earlier end to the reinvestment of bond purchases under the Pandemic Emergency Purchase Programme (PEPP). Currently, these reinvestments are set to last at least until the end of 2024.

Pause at next meeting but hike in December still on the table

Recent developments mean that a pause at the ECB's next meeting two weeks from now has become more certain. However, for the December meeting, a rate hike is still on the table. Prior to the pandemic, most central banks would probably have looked past surging oil prices. Some even considered rising oil prices to eventually be deflationary, undermining purchasing power and industrial competitiveness. However, as we are no longer in the pre-pandemic era, but in the era of stickier-than-expected inflation, the ECB could still be tempted to choose its own credibility over a potential recession in the eurozone.

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