

## ECB preview: Breaking the wave

In recent days, the risk that the European Central Bank could hike by another 75bp has clearly increased



Remember when politicians and policymakers were talking about how they wanted to 'break the wave'? They hadn't turned into a bunch of cool surfers; we were in the middle of several Covid waves, which had to be broken prematurely before they could do too much damage to people's health, life and economic welfare. At the end of 2022, breaking the wave has taken on a different meaning: central bankers first tried to break the inflation wave and markets are now anticipating that the wave of jumbo rate hikes could be broken, both in the US and the eurozone.

### Another jumbo rate hike has become more likely in recent days

The ECB's meeting next week is one of the few meetings at which the central bank will take a decision after the Federal Reserve and not before it. A slowing of the Fed's rate hike pace could have an impact on the ECB as well. At least this is how many market participants have looked at the Bank's next decision for a long while. Recent comments by ECB officials, however, have cast doubt on whether the ECB will actually slow its own rate hiking pace.

Arguments for a dovish shift came from the minutes of the ECB's October meeting in which the Bank emphasised the substantial progress that had already been made in withdrawing policy accommodation. Some ECB members had also highlighted the lags involved in the transmission of monetary tightening and in October, suggested a slowdown in the rate hike efforts.

Macro data since the ECB October meeting has, on the one hand, shown resilience in the eurozone economy in the third quarter but has also confirmed a further cooling of the economy in the last few months of the year. The drop in headline inflation, as little as it says about the impact of the rate hikes so far, could at least take away some of the urgency to continue with jumbo rate hikes. It's symbolic. At the same time, the ECB seems to be increasingly concerned that the fiscal stimulus and support measures announced could extend the inflationary pressure.

A fresh round of ECB staff projections will obviously have an enormous impact on the ECB's discussion and decision. However, given the growing scepticism regarding their own forecasts and models, even an official forecast of inflation slowing to 2% by 2025 might no longer be sufficient to calm the more aggressive central bankers at the ECB.

In any case, the experience of the last months tells us that decoding the ECB's reaction function has become very difficult and there is no longer a small set of reliable indicators, or people, from which we can derive the outcome of the next ECB's decision easily.

ECB Executive Board Member Isabel Schnabel has been one of the more influential voices to watch, definitely since the summer with her Jackson Hole speech. Judging from her recent comments that "Incoming data so far suggest that the room for slowing down the pace of interest rate adjustments remains limited, even as we are approaching estimates of the "neutral" rate.", 75bp is clearly still on the table. Probably even more remarkable was an interview that ECB Chief Economist Philip Lane gave earlier this week. The fact that "the medium term can be longer if the deviation of inflation is not too great, but should be shorter if we have a big inflation gap to fix" suggests that for Lane, a return of inflation to 2% only in 2025 would be insufficient to stop rate hikes. Still, given that the traditional doves have been more vocal in arguing in favour of a smaller rate hike, a 50bp rate hike supported by hawkish communication could also be a compromise.

## Breaking the wave - but which one?

With all of the above in mind, we think that the risk of a 75bp rate hike at next week's ECB meeting has clearly increased. Next to the rate hike, the ECB is likely to set out some general principles of how it plans to reduce its bond holdings. We expect the ECB to eventually reduce its reinvestments of bond purchases but to refrain from outright selling of bonds. In any case, next week's ECB meeting could send us back in time as we witness policymakers still trying to break a wave - a wave of inflation and with it, a wave of speculation around a pivot in monetary policy. What the Bank won't break, is the wave of jumbo rate hikes.

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