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ECB preview: Hiking into a recession

No more gradual and small steps. The only question for next week's European Central Bank meeting is whether it will be a 50 or 75 basis point hike

The ECB is another example of a central bank which has been completely overwhelmed by inflation dynamics and a paradigm shift of major central bankers. Remember that it is not too long ago that the ECB ruled out the possibility of even a small rate hike in 2022. Then, there was the gradual and measured approach for rate hikes which was replaced by a surprise 50bp rate hike in July. Now we are at the so-called meeting-by-meeting (MBM and not MiB) approach. This is an approach which clearly makes more sense and should have been introduced much earlier as it would have prevented the ECB from making the described communication mistakes. The MBM approach, however, is also an approach which opens the door widely for speculation and volatility as it makes it harder to read the ECB's reaction function.

Paradigm shift and in search of the ECB's reaction function

And exactly this reaction function has changed. It follows a paradigm shift of many central banks as recently witnessed at the Jackson Hole symposium. A paradigm shift that is characterised by central banks trying to break inflation, accepting the potential costs of pushing economies further into recession. This is similar to what we had in the early 1980s. Back then, higher inflation was also mainly a supply-side phenomenon but eventually led to price-wage spirals and central banks had to hike policy rates to double-digit levels in order to bring inflation down. With the current paradigm shift, central banks are trying to get ahead of the curve – at least ahead of the curve of the 1970s and 1980s.

Whether the paradigm shift of central bankers is the right one or simply too much of a good thing is a different question. What is striking is the fact that central bankers have implicitly moved away from measuring the impact of their policies by medium-term variables and expectations towards measuring it by current and actual inflation outcomes. This could definitely lead to some overshooting of policy rates and post-policy mistakes.

> *With headline inflation at a new record high... many ECB officials have sounded the alarm bells*

Back to the ECB. With headline inflation at a new record high and continued passing through of high wholesale energy prices to consumers and corporates in the coming months, many ECB officials have sounded the alarm bells. At Jackson Hole, Isabel Schnabel gave a very hawkish speech, calling for aggressive hiking of interest rates in order to prevent inflation expectations from de-anchoring or a price-wage spiral from kicking in. 'Caution', Schnabel said, was the wrong medicine to deal with the current supply shocks. Instead, she called for a 'forceful' response even at the risk of lower growth and higher unemployment. Other ECB members followed, calling for a 75bp rate hike next week. Some explicitly argued to bring the policy rate above its neutral level. Only ECB chief economist Philip Lane took a slightly different stance, calling for a gradual approach.

Intention of aggressive rate hikes – but will it help?

We still find it hard to see how aggressive rate hikes can bring headline inflation down in the eurozone. The economy is far from overheating and will almost inevitably fall into a winter recession, even without further rate hikes. In such a situation, gradual normalisation of monetary policy makes sense, trying to break a supply-side inflation with rate hikes, however, indeed resembles this idea of 'if you only have a hammer, everything has to be treated as if it was a nail'. Admittedly, the situation is difficult for the ECB: demonstrating its determination to bring down inflation would easily be interpreted as panic.

To further identify the ECB's reaction function, we will have a close eye on the newest staff projections, which will also be released next week. Two things will be of importance: how negative or positive will the ECB be on the eurozone's growth outlook for the winter and what are the inflation projections for 2024. Remember that in June, the ECB still expected GDP growth to come in at 2.1%, which is far away from our own forecast of -0.6%. As regards 2024 inflation, the June projections had annual inflation at 2.1%. The more downward revisions we will get on both projections, the less likely the suggested aggressive rate hikes will be.

Hiking into a recession is not the same as hiking throughout a recession

In any case, and even if the ECB doves have been very silent in recent weeks, we expect the ECB to 'only' hike by 50bp next week. This would be a compromise, keeping the door open for further rate hikes. 75bp look one bridge too far for the doves but cannot entirely be excluded. Further down the road, we can see the ECB hiking another time at the October meeting but have difficulties seeing the ECB continue hiking when the eurozone economy is hit by a winter recession. Hiking into a recession is one thing, hiking throughout a recession is another thing.

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