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ECB preview: Resisting the push back

The first question for next week's European Central Bank meeting is how the Bank will react to current market pricing. The second, however, is why should the ECB react to current market pricing. We expect the ECB to stay on hold and give very little indication about the timing of any upcoming rate cut

The eurozone's wage growth drop is firming up expectations of a 25bp cut from the ECB next month

When there is such a stark discrepancy between market expectations and official ECB comments as there is currently, every ECB preview should start with the question, 'What will the ECB do at the next meeting to finally guide markets?'. This preview, however, starts with the question, 'Why should the ECB actually care?'

Macro developments since the December meeting

Macroeconomic news since the ECB's December meeting has been broadly in line with the Bank's staff projections from back then. To give ECB staff (and their models) some credit, the reacceleration in headline inflation in December had been fully captured. Only what currently looks like another contraction of the eurozone economy in the fourth quarter was not fully covered by the ECB's forecasts. In fact, there is a high chance that the ECB's growth forecasts are currently suffering from the same bias as inflation forecasts in the past, namely a too-quick return to potential.

Why the ECB will not meet markets' expectations

Back in December, the ECB basically announced the end of the current rate hike cycle. Financial markets took that signal and the current economic weakness as clear signs of imminent rate cuts. However, even if actual growth continues to turn out weaker than the ECB had expected every single quarter, as long as the eurozone remains in de facto stagnation mode and doesn't slide into a more severe recession, and as long as the ECB continues to predict a return to potential growth rates one or two quarters later, there is no reason for the ECB to react. Definitely not as long as inflation remains off target.

Turning to inflation in the eurozone, the job is not done yet for the ECB. In the coming months, inflation developments will be determined by two opposing trends: more disinflation and potentially even deflation as a result of weaker demand, but also new inflationary pressures due to less favourable base effects, new inflationary pressure as a result of the tensions in the Suez Canal as well as government interventions in some countries, above all Germany.

Against this background of rather more upside than downside risks to inflation, any rate cut at the current stage doesn't make any sense, at least not in the eyes of the ECB. In fact, the new inflationary risks bring back the Arthur Burns argument. No central banker wants to be another Arthur Burns, the Fed chairman in the 1970s who is often said to have cut interest rates prematurely, preparing the ground for a second inflation leg. Or, to put it differently, central bankers missed the inflation upswing; they now want to be fully sure of the inflation downswing and will, therefore, by definition be staying well behind the curve

Why the ECB will refrain from giving more explicit guidance

In the past, central bankers invested a lot of (communication) effort in being readable and predictable. At the current juncture, however, the question is whether the ECB should really care about market expectations. The irony of market pricing right now is that it makes the need for actual policy rate cuts less urgent. Financing conditions have eased since early December, doing the work actual rate cuts should do: supporting growth but also pushing up inflation risks. Consequently, the more aggressive the market prices future rate cuts, the less needed and likely those cuts will be. At the same time, given the high degree of uncertainty surrounding both the growth and inflation outlook, any more explicit forward guidance the ECB might give next week could easily become outdated by actual macro developments. Therefore, the most likely outcome of next week's ECB meeting will be to stress data dependency and to give some insights into potential conditions for a rate cut, without pre-committing to anything.

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