Hawkish pivot by the ECB

While other major central banks made a slight dovish shift this week, the European Central Bank staged a hawkish pivot. It now looks as if the ECB will be devouring doves for Christmas dinner

ECB President Christine Lagarde at today's press conference

During the press conference, ECB president Christine Lagarde confirmed our takeaway from the announced policy decisions: a rate hike by 50bp, a strong determination to continue hiking interest rates on the back of strong upwardly-revised inflation forecasts, the explicit willingness to enter and stay in restrictive territory and the start of quantitative tightening.

Hawkish pivot

While other major central banks have started to prepare for the end of their hiking cycles, the ECB is giving the impression that it has just got started. The phrase that “interest rates will still have to rise significantly at a steady pace” and that “keeping interest rates at restrictive levels will over time reduce inflation” illustrates that the last doves must have left the ECB building. During the press conference, Lagarde added some flavour by saying that increments of 50bp for a period of time looked about right and that the ECB was “in for a long game” and a steady pace. This implies that if the ECB had to draw its own dot plot chart today, it would probably show the deposit rate at 3.5% by the end of 2023, ie another 150bp of measured rate hikes from today.

To understand the ECB’s logic, you have to look into the Bank's own models, even though they have been discredited increasingly by ECB officials. In these models, market interest rates play an important role. In short, market expectations regarding ECB rate hikes up until today's meeting did not bring the ECB's medium-term inflation projections back to 2%. As such, it either needs weaker-than-expected growth, lower-than-expected actual inflation in the coming months or higher interest rate expectations to bring the medium-term inflation projections back to 2%. Prior to today's meeting, markets had the terminal rate (for the deposit interest rate) somewhere between 2.5% and 2.75%. Following the ECB's own logic, it indeed would require a terminal rate for the deposit rate north of 3% to return inflation to 2%.

Market participants know very well never to bet against the central bank. Still, we think that the ECB's growth projections are too optimistic, particularly for the second half of the year. A weaker economic recovery in 2023, combined with the impact of the rate hikes so far, could return inflation back to 2% earlier than the ECB expects and puts the terminal rate for the deposit interest rate closer to 3% than to 3.5%. Obviously, the opposite would hold if we were wrong and the ECB is right. Also noteworthy is the fact that even though the ECB's own technical assumptions show a drop in oil and gas prices in 2024, the headline inflation projections look overly high. Again, we don't dare to bet against the ECB but from where we currently stand, both the ECB's growth and inflation projections could easily turn out to be too high.

At least another 100bp to come

While other major central banks have started to prepare for a dovish pivot this week, the ECB took a rather hawkish turn, though Lagarde denied this was a pivot. While the eurozone economy is probably still the hardest hit of all major economies by the current energy prices and supply chain frictions, it has the central bank with the strongest determination to bring monetary policy into restrictive territory. Consequently, after today's meeting, we now expect the ECB to hike interest rates by another 100bp in the first quarter of next year. A final 50bp hike in the second quarter can also no longer be excluded and only time will tell whether this will then have been a policy mistake or not. In any case, the times in which doves were influential at the ECB are definitely over. Today, it rather looked as if the ECB will be devouring doves for Christmas dinner.

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