ECB slows rate hike pace but ratchets up hawkishness

All good things come in threes…after the Federal Reserve and Bank of England, the European Central Bank has followed with a rate hike of 50bp. The ECB also announced it would start to reduce its bond portfolio, aka quantitative tightening, from March 2023 onwards

Ahead of today's meeting, the question was whether the ECB would opt for a larger-sized rate hike with a dovish message or for a smaller-sized rate hike with a hawkish message. The answer is clear: a smaller hike with a very hawkish message. In particular, the following phrases were surprisingly hawkish: "interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. Keeping interest rates at restrictive levels will over time reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift".

As regards the reduction of the ECB's bond holdings, the reinvestments of maturing bonds under the asset purchase programme (APP) portfolio will decline to €15 billion per month on average until the end of the second quarter of 2023 "and its subsequent pace will be determined over time".

The ECB also already published the results of its latest macroeconomic projections, expecting inflation to come down to 3.4% in 2024 and 2.3% in 2025. The 2024 number was revised upwards significantly. At the same time, the ECB expects only a short and shallow recession, forecasting eurozone growth to come in at 0.5% in 2023 and 1.9% in 2024. This is much more optimistic than our own growth forecast.

All in all, the ECB's crusade to not only fight inflation but to fight against any deterioration in its reputation and credibility continues. There is still very little the ECB can do to bring down actual inflation but it can contribute to re-anchoring inflation expectations. With today's announcement, it is clear that the ECB wants to first fully exploit interest rates as the main instrument to fight inflation and that the balance sheet reduction will stay on the back burner. Needless to say that with the still relatively optimistic growth outlook, the risk increases that the ECB pushes the eurozone economy further into recession with every new rate hike.

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