8 September 2022

Flash: ECB review

75bp, but 75bp is not the new norm

- At today's meeting, the ECB decided to hike all policy rates by 75bp but also stressed that it is not the new norm. Lagarde emphasised the data dependency, but also a meeting-by-meeting approach to calibrate policy rates. This was as we fully anticipated in our *preview*. She guided that at most five meetings with rate hikes were expected, including the ones we have just had.
- The focus is clearly on hiking rates now and discussions on APP reinvestments have been left for later, without specific guidance.
- In terms of technical details, the ECB decided that the tiering system is no longer needed and that government deposits are no longer capped at 0%.
- Growth is heading lower, but the ECB is not yet forecasting a recession. Inflation risks remain on the upside and we remain sceptical that rate hikes will do much to solve the ECB's inflation problem in the near term.

Key takeaways

- 75bp frontloaded rate hike delivered. No specific guidance for QT.
- Further interest rate hikes are likely, but ECB still underestimates recession risk.

Fighting inflation takes precedence over clouding growth outlook

The new ECB staff projections expect a slowdown, with growth stagnating in Q4 and Q1, but without actually forecasting a recession. However, a downside scenario, which takes into account a full Russian gas shut-down, rationing and limited energy savings, sees GDP declining by 0.9% in 2023. Growth risks remain tilted to the downside, as high inflation is taking its toll on spending and production, pent-up services demand is fading and elevated uncertainty is weighing on confidence. However, inflation risks – which remain firmly on the upside – still take precedence over the clouding growth outlook. Another marked upward revision in the inflation outlook, particularly for 2023, and inflation lingering above target in 2024, were important factors behind the ECB's decision to frontload rate hikes.

Today's rate hike will not be the determining factor for whether the euro area falls into recession in our view, but on balance should add to the growth headwinds. Our base case remains that a recession will hit in H2 22. That said, we remain sceptical that aggressive rate hikes will help much in lowering euro area inflation pressures in the near term, which remain largely driven by external forces beyond the ECB's control. Until Europe's energy crisis is resolved, returning inflation back to target will remain a difficult feat to achieve. In the worst case, rising borrowing costs would only further delay the implementation of investments that are needed to solve Europe's energy troubles.

75bp is not the new normal

Lagarde made it clear that a 75bp hike should not be assumed to be the new normal. Looking ahead though, markets are pricing in another 107bp of hikes this year, before flattening out in 2023. We do not change our rate path call, which remains: **50bp in October and 25bp in December, but we remain open to further hikes in 2023 should the economy prove strong enough and inflation expectations remain too high.**

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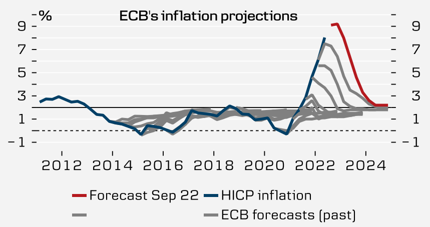
Inflation still above target in 2024



ECB projections September 2022	2022		2023		2024	
GDP growth	3.1% (2.8%)	↗	0.9% (2.1%)	↘	1.9% (2.1%)	↘
HICP inflation	8.1% (6.8%)	↗	5.5% (3.5%)	↗	2.3% (2.1%)	↗
Core inflation	3.9% (3.3%)	↗	3.4% (2.8%)	↗	2.3% (2.3%)	→

Parenthesis are the old ECB projections (from June 2022)

Source: ECB, Eurostat, Macrobond Financial, Danske Bank

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While Lagarde didn't say where she believes the neutral rate to be, she did say that the size of the rate hike decided was based on how the ECB perceives the inflation shortfall to be from the target and how much distance there is to the neutral rate level. The hike size would be set on a meeting-by-meeting basis.

Changes to government deposits

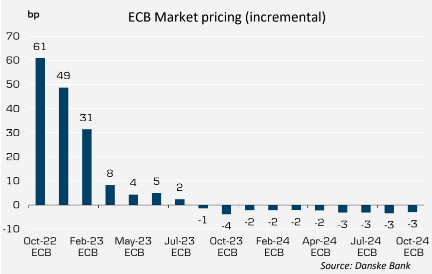
The ECB decided to change its remuneration on government deposits, which was previously capped at 0%. Until 30 April 2023, the ECB will remunerate government deposits (currently EUR502bn) at the deposit rate or €STR (whichever is lower). While this is not very important for monetary policy stance per se, it is very important for the transmission of monetary policy, as it alleviates pressure in particular in the cash bond market. Without this change, we would see continued strain on ASW spreads, as the free float/collateral squeeze would not be addressed.

Government bond yields rose, while ASW spreads tightened markedly on the back of the press conference, mostly in relation to the news of changes in the remuneration on government deposits.

FX had little reaction

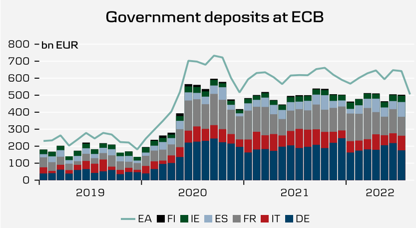
Given that the decision was largely as anticipated, there was little reaction in EUR/USD , which fell back below parity. We continue to see further downside risk with a 12M target of 0.95, with medium-term valuation drivers more persistently weighing on the cross in the quarters ahead. We maintain a bullish USD view, and funding it in EUR is one of several alternatives. Until we see a broad rebound in global growth, a capex boom, a sharp drop in energy prices and/or the Fed cutting rates, we think EUR/USD has more downside in store and today's ECB decision does not change that.

Incremental market pricing of ECB hikes



Source: Macrobond Financial, ECB, Danske Bank

Government deposits at the ECB



Source: Macrobond Financial, ECB, Danske Bank

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Expected updates

None

Date of first publication

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