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GLOBAL ECONOMICS

FLASH REPORT

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ECB: One More Hike With Chance of No More

- **The ECB lifted its three key policy rates by 25bps each at today's decision, as universally expected. Today's statement showed no clear bias in favour of hiking or holding at the September gathering, but Lagarde said at the presser that she would not say that at this time they have more ground to cover.**
- **All else equal, today's ECB, with information to date and the views expressed by policymakers, would likely not hike in September—nor again in this cycle. Sticky core inflation and strong wages growth continues to support our baseline case of a final 25bps increase at quarter-end, but may require inflation surprises.**
- **Guidance on future decisions went from ensuring that interest rates "will be brought to levels sufficiently restrictive" to "will be set at sufficiently restrictive levels", opening the door to a pause—but not closing it to more hikes.**
- **The EUR fell a full 150pips+ from its best intraday levels near the mid-1.11s ahead of the decision and is fighting to hold above 1.10 at writing. The spread of US to German 2-yr yields widened by 14bps from pre-statement levels, with year-end ECB pricing down 5/6bps to still show a ~three-in-five chance of an additional 25bps hike.**

The ECB lifted its three key policy rates by 25bps each, most notably its deposit facility rate to 3.75%, at today's decision. This was universally expected as none among the 60+ economists surveyed by Bloomberg saw other than a 25bps move and the market had the full quarter-point hike locked in.

ECB officials followed through on their guidance that a July hike was needed and would happen and, in line with comments ahead of the decision, today's statement showed no clear bias in favour of hiking or holding at the September gathering.

Lagarde said at the presser, however, that she would not say that at this time they have more ground to cover. The bar for more tightening thus seems to be inflation surprises rather than a continuation of the status quo and forecasts moving roughly in line with expectations.

All else equal, my impression is that today's ECB, with information to date and the views expressed by policymakers, would not hike in September—nor again in this cycle. Sticky core inflation and strong wages growth continues to support our baseline case of a final 25bps increase at quarter-end.

Lagarde was clear, September could be a hike or it could be a pause, and a pause "would not necessarily be for an extended time", alluding to the possibility of a 'skip'—though she did not lean too heavily on this possibility. Lagarde cited the two inflation prints between now and the next decision (first one due Monday) as key figures to inform their data dependent approach; the "burden of proof will be on the data".

We don't know yet where headline inflation will exactly sit in July and August, but inflation markets peg it around 5.2% and 5.0%, respectively, falling to about 3.5% at year-end. Pres Lagarde cited the September forecast round as an important exercise to determine whether policy is sufficiently restrictive. In June, the ECB saw Q4-2023 inflation averaging 2.8% y/y, a bit below the 3% currently penciled in by economists and inflation markets.

A small revision higher may not be enough to motivate a hike, especially if economic projections also see weaker growth and build in a greater tightening of financial conditions. After two more inflation prints, choosing to hold in September would also

show very low conviction that more rate hikes are needed; inflation is meeting forecasts, past hikes are being felt more forcefully, and the doves will start to take over the narrative.

Changes to the key sentences in the statement were minimal to the naked eye, but a small modification stands out that gives it a more neutral feel. Guidance on future decisions went from ensuring that interest rates "will be brought to levels sufficiently restrictive" to "will be set at sufficiently restrictive levels". This suggests that ECB policy decisions may no longer need to be active—meaning more hikes that take rates to a desired point.

Instead, the ECB could stick to passive decisions, so rate holds would still meet the bar for sufficiently restrictive—and in relation to contemporaneous inflation, could be even seen as more restrictive. The ECB hopes it is now just a matter of time for tighter financial conditions to be reflected in a softer inflation trajectory towards the 2% medium-term goal.

There was no clear incentive for the ECB to suggest it may be done tightening, and a data-dependent approach does give them a high degree of optionality but today's decision perhaps failed at reinforcing a high-for-long approach that would check cut bets.

Market reaction

Ahead of today's announcement, markets had 13bps priced in (or about toss-up odds) for the next decision, with a cumulative 21bps by year-end that marked a peak ECB deposit rate a few bps below 4.00%—only a handful of days have markets envisioned a 4%+ peak rate for the current cycle. At writing, September contracts only incorporate about a 40% chance of a hike (~10bps) and December contracts point to a ~60% chance that the ECB chooses to lift rates again by year-end (~15/16bps). From a peak in October/December, markets now see a first 25bps rate cut in May.

The EUR fell a full 150pips+ from its best intraday levels near the mid-1.11s ahead of the decision and is fighting to hold above 1.10 at writing. Broad USD gains are partly behind the EUR's 0.8% loss on the day, as GDP, jobless claims, and pending home sales data all surprised, but for a cleaner read of the market reaction, the EUR is down 0.3% vs the GBP and down 1.3% vs the CAD since the release of the statement. The spread of German to US 2-yr yields widened by 14bps to 188bps from pre-statement levels.

N.B. No changes were made to APP or PEPP guidance, but the ECB announced a surprise change to the remuneration of minimum reserves, with the interest rate paid on these going from the deposit facility rate to 0%. According to the ECB, the move will help to ensure "the full pass-through of the GC's decisions to money markets". This decision has the added advantage of no longer having to pay a high level of interest (now 3.75%) on these parked monies, so it is no surprise that bank shares in Europe took a hit.

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