Comma or full stop?

ECB post-meeting comment

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Contents

Summary

- Today's pause does not necessarily mean the end of the hiking cycle. Yet, policymakers seem to have little desire to tighten further.
- The ECB appeared somewhat more concerned about the growth outlook than in September.
- Lagarde provided no clear reaction function to a potential new energy shock.

Policy decisions

- The ECB **kept rates on hold,** leaving the deposit facility rate at 4.00% and the refi rate at 4.50%.

As widely expected, the ECB announced no changes at today's meeting. Lagarde kept all options open. Yet, Lagarde sounded a bit more dovish than in September. Particularly, we were surprised by the lack of apparent concern that a new energy shock could adversely impact the timely convergence of inflation to the target.

Policy: fully on hold

The Governing Council unanimously decided to leave policy rates on hold. Furthermore, policymakers did not discuss any changes to the PEPP reinvestments or reserve remuneration.

Although President Lagarde underscored that the decision to hold rates unchanged at this juncture *"does not mean we will never hike again,"* the assessment of the economic outlook added a dovish overtone to the decision. Non-committal regarding the likely response to a potential new energy shock (see below) further cemented market participants' beliefs that we have seen the peak of the cycle.

Other policy changes were not discussed either, such as the possibility of ending PEPP reinvestments earlier than communicated. Given the recent rise in yields, it was hard to see why the Governing Council would talk about this option in the first place. With a clear risk of adding fuel to the fire, policymakers had little to gain. Nonetheless, the initial market reaction suggests that some market participants had braced themselves for a potential announcement: Eurozone spreads tightened during the press conference.

Policymakers did not seem immediately worried about the recent rise in yields. Nonetheless, they clearly are paying attention to long-term rates. First and foremost, Lagarde acknowledged that the spillover from higher US rates in particular reinforces the impact of the ECB's policy decisions to date. Secondly, she mentioned that this was not directly related to the fundamentals of the Eurozone. That is debatable. Italian yields have recently printed above 5%, and at some point debt sustainability must become a genuine concern again. Nonetheless, Lagarde's comment could be seen as a veiled hint that the ECB is still willing to intervene if equal transmission of monetary policy across all countries is at risk. Again, PEPP remains an important insurance policy.

Economic outlook: *"je ne regrette rien"*

President Lagarde struck a more dovish tone in her economic assessment today than she did last month, and she certainly didn't make this as hawkish of a hold as we had expected. Is the ECB getting cold feet on the economic outlook?

Asked if Lagarde had any regrets looking back at the first half of her presidency, she responded *"I have no regrets. There's a French song that I will not sing for you,"* referring to Edith Piaf's 1960 hit. Let's hope that she will look back at the remainder of her term with the same sentiment.

Lagarde underscored that the incoming data since the previous meeting had broadly confirmed the Council's assessment. While inflation remains too high, the recent decline was seen as encouraging. At the same time, economic data point to continued weak growth in the coming quarters. And there are now some signs that the labour market is weakening as a result, with fewer jobs being created. The time spent discussing this weaker growth outlook overshadowed the inflation assessment.

The continued tightening of financial conditions supports the ECB's views. Credit dynamics remain weak, as underscored by the latest Bank Lending Survey and the deceleration of monetary aggregates. Amidst tighter credit standards and heightened economic uncertainty, loan demand for both investments and house purchases is falling. Lagarde concluded that this indicates that past rate hikes are being transmitted forcefully, dampening demand and inflation. She did not, however, state how much impact the ECB expects is still in the pipeline.

No clear reaction function to an energy shock

More importantly, President Lagarde did not explicitly outline the ECB's reaction function if a potential escalation of the situation in the Middle East were to lead to another energy price shock. Not even after she was asked if the Governing Council had drawn lessons from the recent energy crisis.

Instead, Lagarde noted that the potential impact of the situation in the Middle East is still being studied. She noted that the situation *"clearly applied to a completely different economy today. An economy that has experienced high inflation, with rates at 4%. And an economy with strong employment, and which is weakening. We have to take all these factors into account to see how possibly higher energy costs would affect* ***both GDP and inflation****."* (Emphasis ours.)

It's particularly surprising to see GDP and inflation being mentioned in the same breath here. Of course, the ECB cannot turn a blind eye to the growth risks of such a scenario. However, inflation is still uncomfortably high. And although most measures of medium-term inflation expectations are near 2%, the Governing Council also admits that some remain elevated and require monitoring. For that reason we had expected a much stronger commitment to act in the event of a new energy shock that would put the inflation outlook at risk. Yet, the statement above does not suggest much urgency or concern about the potential ('non-transitory') impact on inflation.

Although President Lagarde subsequently reiterated that the ECB remains determined to reach its inflation target, her balanced view on the potential impact is on the dovish side and provides much less insulation against potential decoupling of inflation expectations if a new shock were to occur. That could be a missed opportunity she will later come to regret.

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