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ECB delivers hawkish policy update but no follow through to stronger EUR

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- *The ECB raises rates by a record 75bps, and sends strong signal that further hikes will be delivered at upcoming policy meetings. ECB is placing more weight on upward revisions to inflation outlook over weaker growth.*
- *It has reinforced market expectations that the ECB will keep raising rates towards 2.00%.*
- *Higher euro-zone rates are offering support for the euro more broadly but not sufficient on their own to trigger a reversal higher for EUR/USD.*

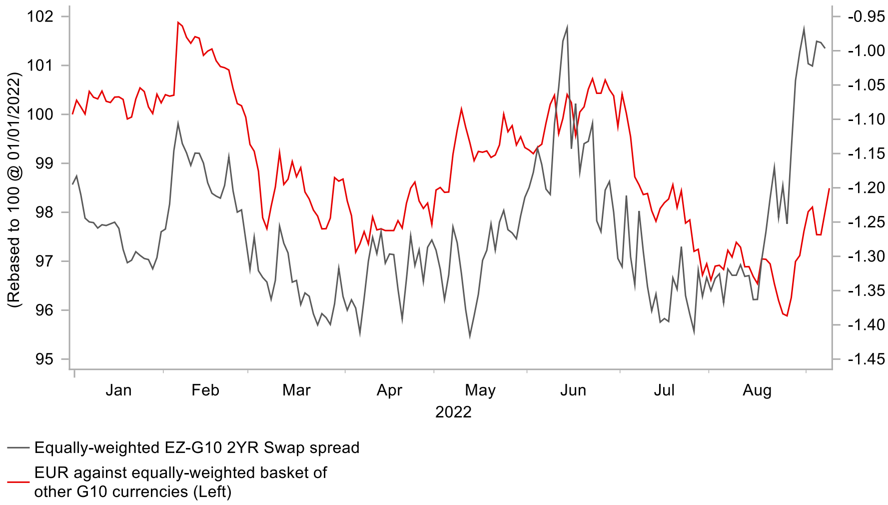
ECB delivers hawkish policy update

The ECB met market expectations by delivering a larger 75bps rate hike at today's policy meeting. It lifted the deposit rate to 0.75%, and it was the largest rate hike ever delivered by the ECB. There had been some uncertainty ahead of the meeting over whether the ECB would continue to hike rates by 50bps, but today's policy statement emphasized that a "major step" was required to "frontload the transition from the prevailing highly accommodative level of policy rates towards levels that will ensure the timely return of inflation to the ECB's 2% medium-term target". Furthermore, the ECB delivered fresh guidance that it is planning "to raise rates further" over the next several policy meetings to "dampen demand and guard against the risk of a persistent upward shift in inflation expectations". The main reason that the ECB is planning further rate hikes is because inflation remains "far too high" and is likely to stay above target for an "extended period". The worsening inflation outlook was reflected by the significant upward revisions to the ECB staff forecasts which now expect inflation to average 8.1% in 2022, 5.5% in 2023 and 2.3% in 2024.

In the accompanying press conference, President Lagarde provided further guidance over plans for further policy tightening. She stated that the next rate hike will not necessarily be 75bps which should not be viewed as the norm now for further policy steps. The size of future hikes will be determined on a meeting by meeting basis as the ECB continues to weigh up economic developments. She believes that the policy rate after today's policy action is still stimulative for the economy, and that there is more work to do to raise the policy rate towards neutral. The ECB is prepared to raise rates above neutral. However, she refrained from signalling how high the ECB is prepared to raise rates in the current tightening cycle. She did though send another hawkish signal by stating that the ECB is still "so far away" from the rate that will return inflation to their 2% target. She also took the unusual step of signalling that the ECB will probably hike at 3 or 4 more meetings. If we assume that the ECB plans to deliver two more 50bps hikes followed by at least one final 25bps hike that would take the policy rate closer to 2.00% or just above. The ECB will continue to focus their efforts on tightening policy through raising rates unlike the BoE and Fed who are allowing asset holdings on their balance sheet to shrink. When asked about quantitative tightening, President Lagarde noted that it was “premature” to look at other policy instrument.

The hawkish update from the ECB sent a clear signal that they are focusing on combating upside inflation risks rather than supporting economic growth. The ECB is prepared to keep raising rates even as the staff outlook for growth was revised down markedly for the remainder of this year and throughout 2023. The ECB staff are now forecasting that growth will slow sharply from 3.1% in 2022 to 0.9%. In a downside scenario where downside risks to growth from the energy crisis are even more disruptive, the ECB staff are forecasting that GDP could contract by -0.9% in 2023.

HAWKISH ECB PROVIDING SUPPORT FOR EUR MORE BROADLY



Source: Bloomberg, Macrobond & MUFG GMR

Market implications

The ECB’s hawkish policy update has reinforced the ongoing sell-off in the euro-zone rate market. Market participants have moved to price in around an additional 16bps of hikes into the curve by early next year. The ECB is currently expected to deliver a 50bps hike in October and in December followed by two further 25bps hikes in 1H 2023 to bring the deposit rate up to a peak of around 2.25%. The ongoing hawkish repricing of ECB rate hike expectations is keeping upward pressure on yields at both the short and long end of euro-zone curves, although the market now appears to be better priced for further hikes based on President Lagarde’s comments today which could help to dampen further upside potential for rates. We still don’t expect rates to rise as high as market pricing as the euro-zone economy slows more sharply than the ECB expects over the winter period.

In the FX market, the EUR has failed to strengthen on the back of the hawkish repricing of euro-zone rates. It provides further evidence that higher rates alone are not sufficient to strengthen the EUR while fears over a sharper slowdown/recession in the euro-zone remain elevated. The negative hit to the euro-zone’s terms of trade from the energy supply crisis continues to weigh heavily on the EUR. President Lagarde stated that the ECB acknowledged that the EUR has depreciated adding to inflationary pressures and that it was closely monitoring the exchange rate. However, the comments were not strong enough to provide more support for the EUR by further encouraging expectations that it would play a key role in further tightening decisions.

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