Euro Area Watch

ECB Review: September is really live

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Economics
Euro Area

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Yes, the job is not yet done

The ECB hiked all policy rates by 25bp this week. Additionally, it clearly signalled that it will likely also increase rates by 25bp at the July meeting. We expected this. But the surprise came from what we thought were very hawkish forecasts, with a significant upgrade to headline and core inflation in the near term but also a move further away from target at the end of the forecasting period (2025).

With these forecasts one would have expected Lagarde to guide us a bit more on what could happen beyond July. But, as we expected, she did not do this. We would add that she was careful enough not to talk about “several hikes”. To us that reflects either large divisions on what to do after July, little trust in some of the drivers of the new forecasts or, likely, both.

In any case, what this highlights is that September will likely be a live meeting in line with our view of a terminal of 3.75% with a significant risk of 4% (i.e. a last hike in September). We don’t think current ECB forecasts will survive in September, hence why we don’t change our call. The (communication) battle for September begins today.

The inconsistency of forecasts and communication

To us, it is inconsistent to present these forecasts and not be willing to signal a bit more than we heard. At the end of the day, given market pricing for the policy rate, inflation does not reach target by the end of 2025, i.e. there is not enough tightening priced in to bring inflation back to target in a reasonable timeframe.

Lagarde could perhaps have told us that the market pricing for cuts indicated insufficient patience. We would agree with that given the cut-off date. She could also have said that, while remaining data-dependent, there was a risk that more was needed given the forecasts. We have heard similar comments from her in the past. Instead, we got nothing beyond a de facto promise to hike in July. This can only reflect strong disagreements, probably fed by a forecasting exercise that, at least to us, raises many doubts.

A slippery slope

These forecasts matter. Will they hike in September? We are not making that part of our base case but continue to flag very significant risks. But we are one large upside surprise away from that. More importantly, focus now clearly turns to these new numbers. We said before that we needed a significant drop in core inflation for the ECB to stop in September. We are expecting this, hence our call.

Refer to important disclosures on page 4 to 5.

But we now also need these forecasts to move lower. If core and headline inflation forecasts survive at these levels by the September meeting, even with lower core inflation by then, they are likely to hike at that meeting, too. And probably they would even need to consider further hikes after September if core looks like staying as high as they expect now in 2024. In a way the ECB is converging to be a bit more forward-looking, but in a very asymmetric way.

Forecasts should move lower

Do we think forecasts will survive the September meeting without moving significantly lower in 2024 and 2025? We are very sceptical; looking at the details we fail to understand how slightly stronger unit labour costs more than compensate for weaker external demand, much weaker energy and food prices, and a slightly stronger currency. And growth forecasts are still too optimistic, even in the very near term. In other words, we would expect a move lower in the medium-term inflation outlook in September when forecasts shift from National Central Banks (in charge in June and December) to the ECB (September and March).

Exhibit 1: ECB forecasts, June vs March

Hawkish forecasts, with a significant upgrade to headline and core inflation

		2023	2024	2025
GDP	**June**	**0.9**	**1.5**	**1.6**
	March	1.0	1.6	1.6
HICP	**June**	**5.4**	**3.0**	**2.2**
	March	5.3	2.9	2.1
Core	**June**	**5.1**	**3.0**	**2.3**
	March	4.6	2.5	2.2

Source: ECB

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Rates

The ECB hiked rates by 25 bp as expected and signalled another hike for July. The market reacted to the sizeable upside revisions in the staff's core inflation projections for 2024 (+50bp). The EUR curve bear flattened and the 2y German yield was up close to 15bp on the day, before retracing lower on downside surprises in US data. President Lagarde did not provide guidance beyond July and refrained from commenting on the terminal rate. This may be due to the Governing Council's desire to show data-dependence, but it could also relate to divisions within the Governing Council over how to proceed past July. Consistent with that, the market is pricing in a 50% probability of another 25bp hike in September.

With risks around Eurozone data surprises skewed to the upside and with heavy government bond supply ahead, we remain biased bearish rates and look for further 2y-5y curve flattening. The ECB's inflation forecasts also reinforce our view that the central bank will persist with high rates, supporting the idea that the bear flattening in 2y-5y can initially turn into a bull flattening (rather than bull steepening) when data weakens - see Global Rates Viewpoint 15 Jun 23).

FX

EURUSD remained higher after the ECB meeting but, for most other EUR crosses, the ECB proved almost a non-event. To us, this suggests EURUSD was more risk sentiment-driven (a post-FOMC reaction and/or a reaction to downside surprises in US data) than ECB-driven. The main news from today's meeting, as our economists note, was the hawkish forecast revisions. But, as we were expecting, we got no explicit guidance for beyond the July meeting. We also note President Lagarde's comment on the need for fiscal policy to be of more help. Going forward, we believe EURUSD depends more on the USD and the Fed. As long as the US economy remains in a "no landing" scenario, we would expect the USD to remain strong and EURUSD historically weak—we forecast EURUSD at 1.05 through the year-end. Only after the inevitable landing we would expect a more sustained EURUSD move upwards.

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