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Euro Area Watch

ECB Review: No trade-off between price and financial stability

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ECB is not done

“No trade-off between price and financial stability” was the clear statement from the ECB's president Lagarde today, or, if we were to summarize: the ECB meeting, beyond saying the outcome was quite close to what we expected, was a clear attempt at applying the separation principle between price and financial stability.

We would not go so far as claiming there is always a separation, there is a very delicate path between the two, but the ECB did a good job today at delivering a dovish 50bp hike and plainly signalled they have the tools and stand ready to act to preserve financial stability if needed.

Beyond that, the message is quite clear: the job is not done, "inflation is projected to remain too high for too long" despite the new forecasts incorporating a move of 50bp in short-term rates relative to the December exercise. Lagarde clearly said that there is “a lot of ground to cover”. In other words, they finally killed forward guidance for good, they remain extremely data-dependent, more needs to be done, they are just waiting for some of the fog to clear.

As long as we see some stabilization in financial developments, our baseline of a 4% terminal rate (which the market was fully pricing a week ago) would still hold. But the balance of risk around the baseline is now more balanced or slightly to the downside.

New reaction function leading to different outcome?

The introductory statement describes in detail a “new” reaction function from here when saying that “the elevated level of uncertainty reinforces the importance of a data-dependent approach to the Governing Council’s policy rate decisions, which will be determined by its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission”.

Those are the three key ingredients that try to incorporate recent developments and at the same time try to balance a bit more the backward-looking reaction function of the hawks (the dynamics of underlying inflation) and the more forward-looking reaction function of the doves.

Does this “new” reaction function deliver a different outcome? We are not convinced. Recent developments have probably helped the doves to convince the rest of being more cautious today and properly ditch forward guidance. But that doesn’t necessarily mean the balance of power has shifted enough within the governing council to have a significantly more forward-looking reaction function.

Refer to important disclosures on page 4 to 5.
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As an example, Lagarde argued that the ECB will want to see clear signs that core is heading lower before stopping hikes. This has been the key reason that we had terminal at core and why we thought they would move by 50bps in May. We have been arguing that the ECB would only become more properly forward looking when the cost of doing so was significantly reduced. That requires core moving convincingly lower towards target. Again, if financial markets stabilize, we would still have strong conviction in that call.

Could tighter credit conditions stop the ECB from delivering so much?
Some could argue that the additional tightening of lending conditions we could end up seeing as a consequence of persistent implications of recent developments would deliver a weaker economy and hence the ECB would end up reaching a lower terminal (i.e., it would remove the need to hike so much). Once again, the issue here is one of timing. As we argue above, we don't think internal dynamics within the ECB have structurally shifted today. They are more cautious, but likely still very backward looking.

This also matters here. Any additional deterioration in lending flows would show in the data with a substantial lag. The ECB would need to be more forward looking for this to play an important role in their decision making. In the meantime, core inflation likely will continue to feed the hawks' narrative. If markets calm down and stabilize, we could easily get to the same point even if lending is a bit weaker.

Rates: dovish interpretation from rates market: we question it

Even as the 50bp delivered was more than what was priced this morning (around 35bp pre-meeting), the market rallied following the monetary policy statement, taking peak €str rate to as low as 3.0-3.1% (implying around 20bp of hikes from here).

The rally was driven by the absence of explicit guidance on the path ahead, with the market interpreting it as a sign that the ECB hiking cycle could be ending with current events in the banking sector. The statement and president Lagarde's comments only referred to the dependence on: (1) the assessment of the inflation outlook in light of the incoming economic and financial data, (2) the dynamics of underlying inflation, and (3) the strength of the monetary policy transmission. Financial market developments create uncertainty around (1) and (2).

We believe the decline in front-end rates on the back of the meeting is overdone, assuming no additional contagion in the Eurozone banking system. As detailed above, recent financial developments may take time to reverberate into the real economy situation, if at all. Also, there is a large gap between "a lot of ground to cover" under the ECB's baseline from early March, and a complete end to the hiking cycle.

Importantly, we also remain reassured by:

(1) The analysis by our European bank equity and credit teams, showing limited change in banks' exposure to bonds over the last few years, their increased holdings of cash, and relatively modest unrealised losses on securities (see European Banks Strategy 13-Mar and European Banks 15-Mar)

(2) The tools at the ECB's disposal to provide more liquidity to banks, and/or support to private bond markets (corporate bonds, commercial paper & covered bonds) – see our list of the top 5 tools that could be deployed in Liquid insight, 16-Mar.

(3) The limited idiosyncratic contagion in European government bond space (where spreads appear to have evolved in line with historical directionalities and where periphery bonds could in fact benefit from increased retail demand (see also Liquid insight, 16-Mar)

FX: balanced meeting, but we still expect the ECB to help (non-USD) EUR crosses

Today's meeting proved largely a non-event for the EUR despite (1) the ECB hiking rates by 50bp, (2) several (explicit or implicit) references by President Lagarde on the underlying inflation pressures, the tight labour market, and the need to tighten by more assuming markets stabilise, and (3) the assurances the ECB has a rich enough toolkit to deal with its objectives. Markets remained skeptical and chose to focus on the lack of clear commitment on the next steps, assigning a probability the ECB is even done with rate hikes. While we understand, we do not agree, and our economists' base case for the ECB depo terminal rate remains 4%, assuming the "market fog" clears.

With Eurozone core inflation yet to peak, labour markets remaining tight, and fiscal policies unhelpful, the ECB has some work to do assuming markets stabilise. On balance, such an outlook and the hawkish ECB should be positive for EUR. As we expect the USD to find support from high US inflation and/or risk-off, we still see downside EURUSD risks in the short term. EUR crosses, however, should perform.

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