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ECB September Meeting Preview: ECB to go big, despite energy crisis

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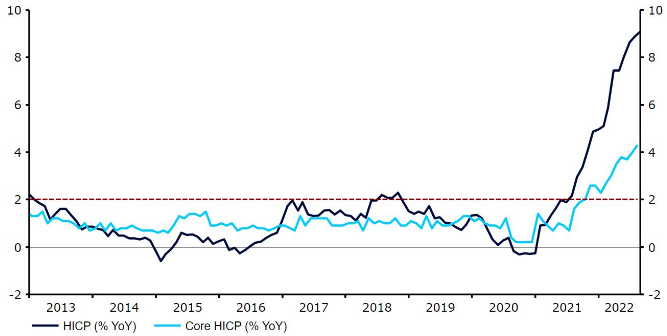
ECB to go big, despite energy crisis

There is a great deal of uncertainty heading into this Thursday's European Central Bank meeting, which looks likely to be one of the most important and also hardest to call for some time.

As expected, the ECB finally began the process of interest rate normalisation at its most recent policy meeting in July, having lagged behind all but the Bank of Japan in hiking rates in the G10 in the current cycle. The Governing Council delivered a larger-than-expected 50 basis point interest rate increase, after most of the market had pencilled in a 'standard' 25 basis point hike. In justifying the move, ECB President Lagarde said that inflation will remain 'undesirably high' for some time, and that a larger move would be appropriate given the introduction of the bank's new Transmission Protection Instrument (TPI), designed to address anti-fragmentation risk in the common bloc's fixed income markets.

We think that this week's announcement is even more uncertain than the last and, as we mentioned earlier in the week, we believe that the ECB perhaps faces the most difficult job of any of the world's major central banks. On the one hand, recent Euro Area inflation prints have continued to surprise to the upside and, as of yet, have shown no signs of abating. Headline inflation jumped to 9.1% in August, and looks likely to rise to fresh all-time highs given the surge higher in European energy prices (Dutch TTF gas prices were up by approximately 320% YTD in late-August, although have since eased).

Figure 1: Euro Area Inflation Rate (2013 - 2022)



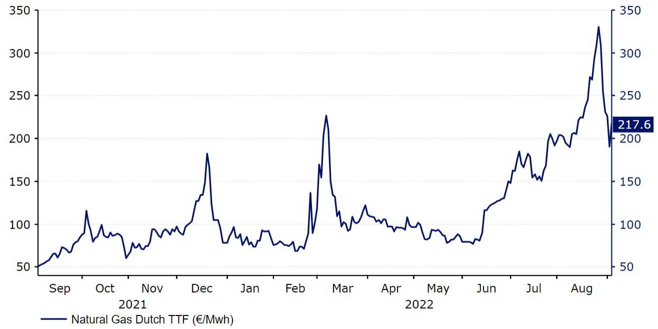
Source: Refinitiv Datastream Date: 06/09/2022

At its June meeting, the bank revised upwards its headline HICP projections to 6.8% for 2022 and 3.5% for 2023, although these are once again woeful underestimations and additional upward revisions here are all but certain at this week's meeting. Labour market conditions in the bloc are also favourable, and recent macroeconomic data prints have actually held up reasonably well under the circumstances. That said, we have begun to see signs of a deterioration in the soft data, particularly in the business activity PMIs, which are now printing below the level of 50 representing contraction.

On the other hand, and a major cause for concern for policymakers, is the rather dire outlook for the Eurozone economy in the near-term in light of the ongoing crisis in European energy markets. Last Friday's announcement from Gazprom that it would be shutting down the Nord Stream 1 gas pipeline 'indefinitely' is a very significant development. Not only does this provide a clear downside risk to the economy, but a very valid argument for a slightly more cautious approach in tightening policy.

At the very least, we expect this to be reflected in a more dovish set of communications from President Lagarde, a downward revision to this month's GDP forecast for 2022, and an admission that a mild technical recession may be on the way in the Euro Area in late-2022 or early-2023.

Figure 2: European Natural Gas Prices (2021 - 2022)



Source: Refinitiv Datastream Date: 06/09/2022

The main uncertainty heading into Thursday's meeting is the magnitude of the pending interest rate hike, with either a 50bp or 75bp move the likely alternatives. Ultimately, we think that the ECB will still opt to raise interest rates by 75 basis points, in line with market expectations, as it prioritises controlling inflation over all else. We note that the slow approach taken by the bank means that interest rates are well below the estimate of the neutral rate, and that policy still remains highly accommodative, particularly at a time of near double-digit inflation. There is, of course, also nothing that the ECB can do to alleviate energy shortages or conjure up gas. A 75bp hike would also send a clear signal to markets that the ECB is determined to control inflation, and may help to anchor inflation expectations.

That said, we think that the magnitude of the hike will be heavily debated among policymakers, and that the decision between a 50bp and 75bp hike will be a close call. A handful of ECB members have already voiced concerns over a more rapid pace of policy normalisation, including chief economist Lane, who last week urged for a 'steady pace' of interest rate hikes. We acknowledge that there is merit to such an argument, notably the risk of heightened fragmentation and the possibility that the bank could be forced to trigger its transmission protection instrument (TPI). We do, however, think that the risk of letting inflation spiral wildly out of control is too high, and that most members would agree with this assessment.

How could the euro react to the announcement?

The most important variable for markets heading into this week's meeting is the magnitude of the ECB's interest rate hike. At the time of writing, swaps are pricing in more than a 90% chance of a 75 basis point hike, so anything less than this would be seen as a significant disappointment for markets and would highly likely trigger a sharp, knee-jerk sell-off in the euro. The reaction in the common currency to a 75bp rate increase would be dependent on a number of factors, namely the bank's assessment on the growth outlook, its updated inflation projections and its forward guidance (or lack of it) regarding future policy moves.

Should the bank warn over the possibility of a deep recession, while indicating that it may raise rates at a slower pace than markets expect (172 bps priced in by year-end), then the euro would fall. By contrast, a slightly less pessimistic assessment, combined with rhetoric that leaves the door open to another large rate increase at the October meeting (of either 50 or 75 basis points) would likely be seen as bullish for the common currency. In the backdrop of the dire situation in European energy markets it may, however, be difficult for the euro to post any meaningful gains after the meeting, particularly against the US dollar.

The ECB's policy decision will be announced at 13:15 BST (14:15 CET) this Thursday, with the press conference to follow 30 minutes later.

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