# ECB: AT THE PEAK

**In its latest meeting, the ECB Governing Council decided to tighten policy further, bringing the deposit rate to 4.00%. It considers that the current level of official rates, if maintained for a sufficiently long duration, will make a substantial contribution to bring inflation back to the 2% target in a timely way. Financial markets rallied, expressing a conviction that policy rates have reached their cyclical peak. The focus is now shifting to how long they will stay at this level and what will be the pace of easing thereafter. The ECB's reaction function depends on the assessment of the inflation outlook in the light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. This leaves a lot of room for interpretation and market speculation. A clearer description of the reaction function would be helpful to avoid that interest rates and financial markets in general would become unduly volatile.**

There's a saying that a picture is worth a thousand words. Judging by the reaction of financial markets (charts 1-3) to the announcement of the ECB's Governing Council decision on 14 September, something significant and market-friendly had happened, causing a drop in bond yields and the euro as well as an equity market rally.

Obviously, in the world of central banking, nuances matter so one needs the words to accompany the charts. Admittedly, policy rates were raised again -for the tenth time in a row-, bringing the deposit rate to 4.00% -an all-time high-, but the Governing Council now considers "*that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target.*[1]" This suggests that, based on the current data, policy is now sufficiently restrictive in the pursuit of the ECB's inflation objective, which might imply that official rates will not have to be raised further in the near term. As time goes by, the impact of past rate hikes should become increasingly visible, which reduces the likelihood that after a pause, the ECB would hike again. In plain English, the announcement means that policy rates are at their peak, which explains the market reaction. Bond yields declined because the risk of further rate increases has dropped if not disappeared completely. The latter factor implies a slight reduction in the uncertainty surrounding the growth outlook, which triggered an equity rally through a decline in the required risk premium. Lower bond yields also helped of course. The euro weakened against the dollar because the Federal Reserve may continue to raise its official rates.

Clearly, there is a difference between what the ECB says and the market's interpretation. The ECB communication must have some ambiguity because the Governing Council needs to keep its options open[2], should disinflation be disappointingly slow or even stop. Moreover, an unambiguous message of 'this is it', could cause a lasting and significant easing of financial conditions -lower bond yields, higher equity prices, a weaker euro- that would neutralise part of the economic impact of high policy rates.

GERMAN BOND YIELDS: INTRADAY 14 SEPTEMBER 2023

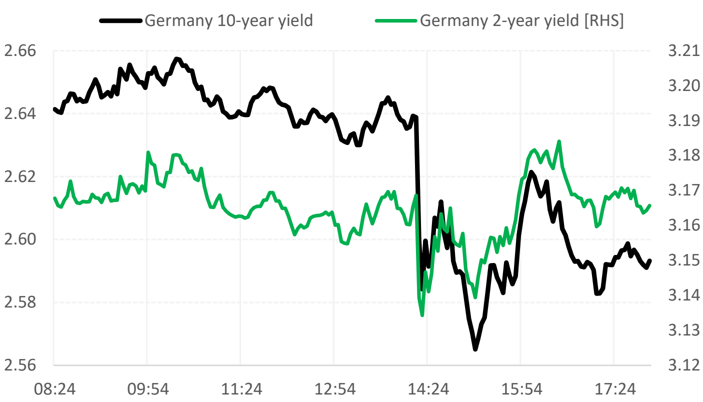


CHART 1 SOURCE: BLOOMBERG (14.09.2023), BNP PARIBAS

Finally, it is unlikely that at this stage a sufficient majority would be found amongst the members of the Governing Council to send such a strong signal. Some commentators nevertheless called the decision a 'dovish hike', based on their view that this should be the last one in this cycle. However, Christine Lagarde's comments during the press conference didn't exactly sound dovish[3]. She insisted that the decision was based on the current assessment -so this should evolve based on the incoming data- and emphasised the time element -keeping rates high for a sufficiently long duration-, adding that a comparison of the inflation outlook up until 2025 with the ECB's commitments and 2% target, showed that the ECB is "*not there yet*". Restrictive monetary policy is economically painful even when rates are at a plateau.

1Source : ECB, Monetary policy statement, 14 September 2023.
2 ECB President Lagarde even said during her press conference *"We are not saying either that we are now at peak."* Source: ECB, Press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, *14* September 2023.
3 Hawkish and dovish *"are the terms economists use to describe the extent to which communication indicates whether monetary policy is expected to tighten (hawkish) or loosen (dovish)."*- Source: How words guide markets: measuring monetary policy communication, The ECB Blog, 9 August 2023

> A clearer description of the ECB's reaction function would be helpful to avoid that interest rates and financial markets in general would be unduly volatile.

# EDITORIAL



Given the expected stability of official rates, one might think that the upcoming Governing Council meetings will be boring. The reality should be different. To anticipate the timing and pace of rate cuts, analysts will shift their focus to understanding the ECB's reaction function. The ECB President repeatedly mentioned that interest rate decisions will be based on the assessment of the inflation outlook in the light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. Concerning this last factor, the Governing Council is of the view that this "*channel of transmission is strong and stronger than we have seen in previous cycles.*[4]" The two other factors leave a lot of room for interpretation and market speculation: how will incoming data change the inflation outlook, what is a satisfactory pace of disinflation? A clearer description of the reaction function would be helpful to avoid that interest rates and financial markets in general would be unduly volatile. Despite the likely stability of policy rates, the ECB press conferences will be as interesting as ever.

**William De Vijlder**

EUROSTOXX 50: INTRADAY 14 SEPTEMBER 2023

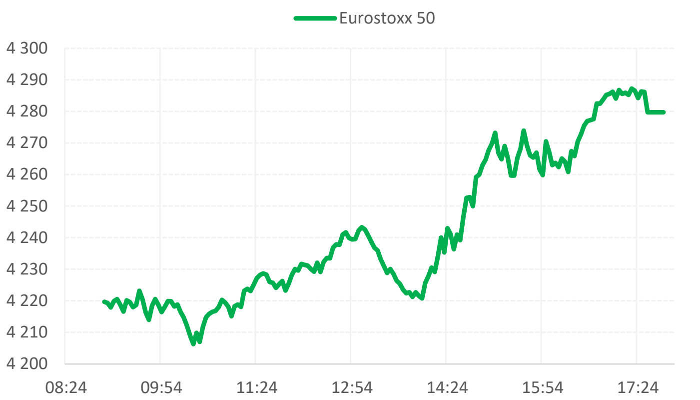


CHART 2 SOURCE: BLOOMBERG (14.09.2023), BNP PARIBAS

EUR/USD: INTRADAY 14 SEPTEMBER 2023


CHART 3 SOURCE: BLOOMBERG (14.09.2023), BNP PARIBAS

4 Source : see footnote 2.