

December 15, 2022

ECB December Meeting: Rates up by 50bp, QT plans unveiled



- ECB raises its deposit rate from 1.5% to 2.0%, as expected by the consensus
- Warns of further rate hikes to come - meeting perceived as hawkish
- Inflation remains “far too high” – projections revised up
- QT will begin in March at an average pace of EUR 15bn per month

In line with actions taken by the US Federal Reserve and the Bank of England, today, the

European Central Bank slowed its pace of hiking, opting for a 50bp hike, as opposed to the bumper 75bp hikes enacted at the past two meetings. This brought the main deposit rate to 2.0%, the highest level since 2008. Looking forward, future guidance was hawkish, with the central bank stating that rates must still rise “significantly” to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% target.

“We should expect to raise interest rates at a 50 basis-point pace for a period of time,” President Lagarde told a news conference. *“We have more ground to cover, we have longer to go and we are in for a long game.”* She added that markets hadn’t adequately baked in the amount borrowing costs would need to rise to quell inflation. Before the meeting, prices implied a terminal rate of 2.93%.

How high borrowing costs will ultimately be pushed is now the key question. A 2% deposit rate is in the vicinity of the “neutral level” that should neither constrain nor stimulate growth. But several officials have called for further moves into restrictive territory.

With regard to growth, the ECB conceded that the Eurozone economy may contract in the current quarter and the next quarter but said that a recession would be “short-lived and shallow”.

Despite a small decline in the headline figure from 10.6% to 10.0% in November, the ECB noted that inflation remains “far too high” and that price pressures remain strong across sectors. For now, fiscal measures to protect households from skyrocketing energy bills are dampening inflation but Lagarde warned that this will not be the case when those measures are withdrawn. In turn, the ECB has significantly revised its projections upwards:

ECB: December inflation projections

	2022	2023	2024	2025
Average inflation	8.4%	6.3%	3.4%	2.3%
Average inflation ex-food and energy	3.9%	4.2%	2.8%	2.4%

The ECB is cautious about the fact that in response to high inflation, wage pressures have been firming, supported by a strong labour market. Eurozone unemployment sits an all-time low of 6.5%.

The most anticipated point at this meeting was details on quantitative tightening (QT). It was announced that the ECB will begin winding down its €5 trillion bond portfolio from March. This will involve partially halting reinvestments of maturing bonds under the Asset Purchase Program, targeting volumes of around €15 billion a month in the second quarter, with the pace beyond that yet to be determined.

Overall, the meeting stirred markets. While the 50bp rate hike was well expected, the hawkish undertones were not: especially the comment that rates would still have to rise “significantly”.

The yield on the 10y German bund shot up by 15bps to 2.10%, while communication on balance sheet reduction pressured the bonds of peripheral countries, leading to spread widening.

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