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To the point!

Cross-Asset- and Strategy-Research

# The ECB must hold its nerve

**Inflation is still far from defeated. Expect 50 basis points next week.**

Inflation in the euro area has been in reverse gear for two months. After peaking at 10.6% in October, the rate of price increases dropped to 9.2% at the end of the year. Of course, this is still miles away from the ECB's 2% target. Nevertheless, the downtrend has buoyed markets, possibly in anticipation that the ECB might back away from the surprisingly hawkish rhetoric of the December meeting.

Fabio [Panetta](#), a member of the ECB's Executive Board, seemed to suggest in an interview this week that further interest rate steps after February were completely open. Presumably, the majority of the central bank council may have read Panetta's statements with a frown. He is known to belong to be as dovish as it gets and unlikely to paint a representative picture of the mood of the now 26 members (welcome Croatia!).

## The ECB will increasingly look at the core rate

And that's just as well. After all, a renewed volte-face in ECB communication following the surprisingly hawkish stance in December would hardly be conducive to the institution's credibility. But more fundamentally, there is no reason at all to loosen the monetary reins again.

The decline in inflation is almost exclusively due to falling energy prices. Just as the meteoric rise in prices had been driven primarily by the surging cost of energy. The decline in inflation simply has nothing (yet) to do with the tightening of monetary policy since the summer.

The core rate of inflation, which excludes volatile components such as energy and food, continued to climb in December, reaching an all-time high of 5.2%. Moreover, forecasters see the



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## The doves come out of hiding

### Euro area inflation rates, in %



Source: Refinitiv, LBBW Research.

core rate remaining above target until at least to the end of 2024 (at 2.4%, also a record for this forecast period).

That's why we should expect a 50bp rate move to be delivered not only next Thursday, but also at the following session in March. We then expect a final 25 bp hike in May to reach a deposit rate of then 3.25%.

After that, it's probably over. Why? The ECB will publish its own inflation forecast at the June meeting. I expect that it will forecast a lower medium-term inflation rate close to the target value. Such an outlook would stand at odds with further interest rate hikes.

### Don't throw the baby out with the bathwater

On the other hand, some statements made by the hawks seem exaggerated. The Dutch central bank governor [Klaas Knot](#) spoke at Christmas of the ECB now entering the "second half" of rate hikes. By definition, halves are of equal length. The ECB has raised interest rates by 2.5% since July and now stands at 2% (deposit rate). At the end of the second half, we would then be at 4.5%.

This is almost certainly far too high and would significantly increase recession risks. And possibly, after the two halves, Knot might want to go into extra time and maybe even to a penalty shootout, as the Dutch Oranje team unsuccessfully did last month against eventual world champions Argentina.

That would be too much of a good thing. As already described [in this column](#), declining energy prices could lead to a renewed undershooting of inflation below 2%. Frankfurt would then be forced to cut interest rates again, and quickly. The hawks can't want to go on this roller coaster ride either.

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## Deposit rate peaks at 3.25% in May

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## The ECB must not overdo it with the interest rate hikes either

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