ECB: Higher for Longer (inflation, ergo also rates)

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CITI'S TAKE

The straightforward explanation provided by the Governing Council for today's hike causes us to revise our expectations for the path of policy from now onwards. We now expect the policy rate to be raised again in December 2026 and March 2027 by 25bps, bringing it to 3% before a plateau may be reached. We insist that this modal expectation is very dependent on energy prices remaining high. The key element of communication we took away today is that the longer inflation remains high, the more pronounced the risks that it becomes endogenous, even if no second-round effects are immediately evidenced. Given that the current tensions on energy prices extend the period of above-target inflation, this leads in our view to a shortening of the policy horizon of the ECB, and a drift in policy preferences towards a "risk management" approach. Both speak to higher rates than we had in mind.

ECB: Higher for Longer (inflation, ergo also rates)

Three criteria, but only one matters: The "framework" often put forward by the Governing Council of the ECB as a guide to its deliberations includes three criteria: the underlying dynamics of inflation, the strength of transmission of monetary policy, and inflation projections. In today's communication, the ECB conveyed no concern on the first; it did not comment on the second; but it abundantly emphasised the third, including by underlining in the policy statement that "inflation is set to remain well above target for an extended period." Further, the President insisted that the longer inflation remained above target, the higher the risk of de-anchoring of expectations. That suggests an evident asymmetry of the roles of the three criteria in the policy debate.

First, under this approach, the longer inflation stays above target, the shorter the policy horizon effectively becomes. We had highlighted in the preview that a shorter policy horizon would undermine the credibility of our modal expectation of a plateau of rates at 2.5%. We therefore have to review our characterisation of the reaction function accordingly. Second, it follows from this statement that if inflation lasts for longer than initially expected, the reaction function must mechanically drift towards more of a "risk management" approach, which implies more appetite for hikes, all else being equal.

Energy prices remain the main driver (and risk) to the policy path: Given the acknowledged absence of second-round effects or wage pressure, it seems to us that the policy path remains very dependent on the direction of energy prices. The President of the ECB was more upbeat than we are on the labour market, which she qualified as “robust,” while we see job destructions in Germany and France as more of a concern. Still, negotiated wage growth expectations at 2.7% in 1H 2027, as referred to by the President, do not strike us as representing much of a risk of endogenous inflation. The President also noted that if the Governing Council had been surprised by domestic inflation developments, it was more on the downside (food prices) than on the upside. By elimination, that makes energy prices still the main driver of the inflation projections, and therefore of the likely policy path, all the more so if the policy horizon is reduced.

We underline this because it can alter our expectations both ways. We now expect rate hikes to take place at a quarterly pace on meetings where new projections are unveiled. We find this alternation of hikes and pauses hard to justify theoretically, but they seem to be the empirical prevailing pattern. But if energy prices are indirectly the main driver of policy, a sharp move in either direction would likely cause us to reflect that in a faster or slower tightening path. Another factor that may have a bearing on the reaction function of the ECB would be an early replacement of the President, which we think is plausible before the March 2027 meeting, and that contributes to our expectations remaining relatively fluid at that horizon.