No Rate Hikes on the ECB's Horizon

The July meeting of the ECB's Governing Council was the first to be held since it changed its inflation target following a strategic review of its policy framework and objectives. The new inflation objective is now a symmetric 2% target compared to its previous 'close to, but below 2%'. This implies that the ECB will allow inflation to run above its 2% target for a short period of time, if required. The meeting saw the ECB alter its forward guidance on interest rates to be consistent with the new inflation strategy. It now states that it expects its key interest rates to remain at their present, or lower levels until three key criteria are met.

Firstly, and most significantly, that inflation is viewed by the ECB to be reaching its 2% target well ahead of the end its forecast horizon, which is three years. Consistent with this three year time horizon, the current ECB economic forecasts cover the period 2021 to 2023. ECB President Lagarde stated that "well ahead" could be interpreted as meaning the midpoint of this horizon. Secondly, that inflation is durable for the remainder of its projection horizon. Thirdly, that the ECB judges underlying inflation to be consistent with inflation stabilising at its 2% target over the medium term (i.e. beyond the 3 year forecast horizon).

In terms of its outlook for inflation, the ECB is currently forecasting the rate will rise from 0.3% in 2020 to 1.9% this year, driven higher by a big jump in energy prices in particular. It is projecting that the rise in 2021 will prove temporary, with inflation falling back to 1.5% in 2022. Its 2023 inflation forecast is 1.4%. Core inflation, which excludes energy, is forecast at 1.1% in 2021, 1.3% in 2022 and 1.4% in 2023. The ECB commented after the meeting that the outlook for inflation over the medium term remains subdued.

Taking account of these inflation forecasts together with its new forward guidance, would suggest that the ECB does not envisage hiking interest rates during its current forecast horizon, i.e. before end 2023. Indeed, with both headline and core inflation forecast to be well below 2% in 2023, it is hard to see the ECB starting to raise rates in 2024. Not surprisingly, President Lagarde was asked at her press conference that based on its new criteria, why the ECB is not providing additional stimulus to help it achieve its new 2% inflation target.

In terms of market expectations, futures contracts suggest that traders do not envisage official ECB rates being increased from their current level of -0.5% until 2024. Thereafter, rates are viewed as rising at a snail's pace and are still seen as being in negative territory by end 2026. Negative interest rates were first introduced by the ECB back in 2014. The new ECB inflation target and forward guidance on monetary policy has cemented interest rates remaining in negative territory for years to come.

Bond markets in the Eurozone have taken this on board, with yields anchored at very low levels, despite signs of a strong rebound in economic activity in recent months. Irish bond yields are negative all the way out to the ten year part of the curve. Thirty year bond yields stand at just 0.65% in Ireland, 1.2% in Spain and 1.65% in Italy.

This means that Eurozone governments can finance large scale, long-term borrowings at very low interest rates to help their economies recover from the Covid pandemic. It also makes high government debt levels much more sustainable.

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