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ECB May Sense Neutral as Fiscal Finally Emerges

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The ECB's March meeting happened against a backdrop of momentous changes on Europe's fiscal front. Ever since Draghi's "whatever it takes" speech in 2012, monetary policy in the euro area has been front and centre, with fiscal in the back seat. We are now witnessing a role reversal. The ECB has cut its policy rate by 150 bps since last summer. But with fiscal now stepping up, we think the ECB may be largely done with its rate cuts. Any subsequent moves will be steered by incoming data in a world of increasingly fat tails.

Our Take on the Meeting

As expected, the ECB cut its main policy rate by 25 bps on Thursday, bringing the base rate to 2.5%. Alongside the policy decision, ECB staff updated their euro area projections that point to weaker growth and higher inflation. That said, these numbers bring the ECB more in line with consensus. In any case, the latest projections do not reflect the significant fiscal announcements made by Germany and the EU in the preceding days, so, in some sense, were stale on publication.

A key message from President Lagarde's press conference is that the region is facing "phenomenal" uncertainty that requires maximal optionality from a monetary policy perspective. From ongoing geopolitical tensions, renewed trade wars, and major policy shifts in Europe, the outlook is particularly clouded. The ECB is not pre-committed to a particular policy path, and incoming data will determine the future direction of policy rates.

The ECB's emphasis that policy rates are now "meaningfully less restrictive" suggests that the central bank is largely done when it comes to further rate cuts. We took the messaging as slightly hawkish and revised our policy forecast to only one more 25 bp rate cut this summer, potentially bringing the deposit rate to 2.25% by year end, which would be the top end of the ECB's estimate of the neutral rate.

Fiscal, Finally

The March ECB meeting arrived hot on the heels of another "whatever it takes" moment for Europe. The recent EU and German proposals for increased defence and infrastructure spending amount to a little over €300 billion per year, or approximately 2% of EU GDP annually. This marks a major turning point for Germany and the EU, to which financial markets responded accordingly. It is too soon for the ECB to have fully digested these fast-moving developments at its latest meeting. So, what is the expected impact on the outlook?

First, the amounts proposed are a complete game-changer for the macro outlook. Higher fiscal spending should boost growth, as President Lagarde acknowledged at the press conference. But defence spending tends to be less of a boost to growth than other types of fiscal, and public infrastructure projects are rarely "shovel ready." That said, any positive sentiment boost on the back of these announcements could unlock the long-awaited rise in consumption and investment, which could boost growth more quickly. The incoming data will clarify the growth trajectory.

Second, higher spending could mean stickier prices, particularly in an environment where past inflation shocks are still working their way through the system. We are at the very tail end of these inflation remnants with clear signs that wage growth is easing, for example. So, this is perhaps a relatively contained risk for the ECB, at least for now.

The bottom line is that the combination of higher growth and contained inflation means the ECB can sit squarely in neutral territory. It already signalled that it was headed in that direction, but these latest developments provide greater conviction around that endpoint. On the back of these recent fiscal announcements, the risk of recession and the need for cutting rates into accommodative territory has been pushed further into the tails.

Market Reaction

Prior to Thursday's meeting, the markets were pricing in three 25 bp rate cuts at each of the upcoming meetings (i.e., in March, April, and June). However, the abrupt shift in the continent's fiscal stance repriced those expectations.

After the German bund market posted positive returns in February, the 10-year bund yield has jumped by nearly 50 bps, with most of that move coming in the two days prior to Thursday's ECB meeting (Figure 1). Markets are likely to remain volatile as more defence spending details emerge and until the ECB provides more clarity on its monetary policy stance.

FIGURE 1: The bund market may see further volatility on additional defence spending details.

Source: Bloomberg

That said, we see the repricing largely as a reflection of the news regarding fundamentals, and, as such, it appears orderly. The rise in bund yields is broadly consistent with other European sovereign rates, suggesting fragmentation risks remain well contained.

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