

## ECB preview: The final countdown

The European Central Bank looks set to hike rates by 25bp on Thursday. With the bleak economic outlook and disinflation gaining traction, however, the end to rate hikes is near



The eurozone's wage growth drop is firming up expectations of a 25bp cut from the ECB next month

Maybe it's a question journalists should ask at Thursday's press conference but at least to us, ECB president Christine Lagarde's music taste is a well-kept secret. We simply don't know whether Lagarde's record collection includes the epochal "Je t'aime moi non plus" by the just passed away Jane Birkin and the late Serge Gainsbourg. Or whether Lagarde listens to the more contemporary French singer Soko and "I will kill her" when she thinks of inflation at night. In any case, as a true European, we can see Lagarde putting on good old Swedish glam rockers in tights and with a perm, for Europe and their 'Final Countdown' at Thursday's press conference: the countdown to the end of rate hikes has started.

### Rate hike by 25bp on Thursday is a 'no brainer'

A 25bp rate hike at Thursday meeting is a 'no brainer'. Not only did Christine Lagarde basically pre-announce the rate hike at the June meeting, macro data released since that meeting have not fundamentally changed. In fact, the worsening of soft indicators continued, headline and producer price inflation continued to come down, while core inflation slightly increased, and hard macro data confirmed that the eurozone economy has not left stagnation (yet) in the second quarter. Against this background, the ECB's June macro projections look once again too optimistic; particularly as regards growth. Remember that the ECB expects the eurozone economy to return to 0.3% quarter-on-quarter GDP growth already in the second quarter and a return to potential

growth of 0.4% QoQ from the fourth quarter onwards. However, the ECB's determination to continue hiking rates as demonstrated at the June meeting and in the recently published minutes of that meeting is still much stronger than any possible doubts that its own forecasts could (once again) be wrong.

## Discussions at the ECB on where to go beyond the July meeting will become more controversial

Looking beyond the July meeting, signs of a cooling economy and fading inflationary pressure will make the discussion at the ECB about how far to go more controversial. In fact, with still lower-than-expected energy prices, dropping food prices and fading pipeline price pressures in both services and manufacturing, inflation could come down faster than the ECB expects, at least after the summer.

Don't get us wrong, we still believe that, structurally, inflation will be higher over the coming years than it was pre-pandemic. Demographics, derisking and decarbonisation all argue in favour of upward pressure on price levels. However, be cautious when hearing comments that inflation will never come down. These comments might come from the same sources that only a few years ago argued that inflation would never surge again. This does not mean that the loss in purchasing power as a result of the last inflationary years will be reversed any time soon. It only means that headline inflation can come down faster than currently anticipated. Finally, historical evidence suggests that core inflation normally lags headline inflation while services inflation lags that of goods.

As a consequence, the path for the ECB beyond the July meeting will be highly determined by whether the ECB will be right with its optimistic growth outlook or whether growth will remain sluggish. While the former argues for more rate hikes, the latter would make more rate hikes less likely. With the past misses, the ECB can simply not afford to rely too much on its own forecasts and market expectations. Even though, it is a strategy that by definition is ill-suited for forward-looking monetary policy, the ECB will continue focusing on actual inflation dynamics and the pass-through to the real economy. We still think that the disinflationary process will gain more traction only after the summer and that the current sluggishness of the economy will not yet be sufficient to stop the ECB from hiking one last time in September.

## Communication will be key to avoid any misguidance

For the ECB, the focus on actual inflation dynamics rather than being forward-looking has made the current meeting-by-meeting approach the best strategy. Even if the end of rate hikes seems to be near, the ECB will clearly not have a unanimous view on Thursday on where and when this end will be. This is why we expect the ECB to continue with tough talk on Thursday, keeping the door for another rate hike in September wide open. But it will be tough talk but without any pre-commitment as in June. As a consequence, the biggest communication challenge on Thursday will be to say as little as possible to avoid any communication mistakes. Maybe instead of holding a long press conference, Christine Lagarde should just think of Danish writer Hans Christian Andersen, who once said "where words fail, music speaks" and put on Europe's 'Final Countdown' on Thursday afternoon.

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