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ECB stuck in sequencing

For next week's European Central Bank meeting, the only really interesting question is why it doesn't start hiking rates immediately instead of waiting until July

Over the last few weeks, ECB officials have flooded international media with comments and views on what the ECB should do next. Based on all these comments, it is clear that the central bank has definitely passed the stage of discussing whether and even when policy rates should be increased. The only discussion seems to be on whether the ECB should start with a 25bp rate hike in July or a 50bp hike. In this regard, it was very remarkable that both ECB president Christine Lagarde and ECB chief economist Philip Lane have tried to take back control of this particular discussion. In an interview released on Thursday morning, Lane broke with the previous ECB communication strategy to never pre-commit. Instead, he spelled out the roadmap for normalising monetary policy, de facto announcing an end of net asset purchases in early July, a 25bp rate hike at the ECB meeting on 21 July, and another 25bp rate hike at the September meeting. There is nothing wrong with the content of his remarks as it is exactly what we have already been expecting the ECB to do. However, a de facto pre-announcement almost two months ahead of the 21 July meeting is remarkable, to say the least.

Fresh round of staff projections

The economic backdrop for next week's meeting is also clear: the eurozone economy has not (yet) fallen off a cliff but is looking into a very fragile and uncertain future. Stagnation and even a recession are still on the cards. Even if business sentiment indicators have been holding up surprisingly well, weak expectations, consumer confidence at record lows, and high energy and commodity prices do not really bode well for the eurozone's economic outlook. The latest EU decision to (partially) ban imports of Russian oil will also weigh on the outlook, even though it has come too late to be incorporated into the ECB's latest round of staff forecasts. Regarding these forecasts, we expect another upward revision of the inflation forecasts for 2022 and 2023 (5.1% and 2.2% respectively in the March projections). The most interesting forecasts will be the inflation forecasts for 2024. In March, the ECB expected inflation to come in at 1.9% in 2024. Anything higher than that will be welcome arguments for not only normalising monetary policy but going far beyond that. Regarding growth, we expect ECB staff to revise downwards its projections for 2022 and 2023 (3.7% and 2.8% respectively). Higher interest rates since the March meeting, higher oil prices, and more uncertainty make it hard not to revise growth downward.

Since last December, the ECB has made an enormous u-turn in its reaction to structurally increasing inflation. It has not only been high inflation but also the fact that the ECB has structurally underestimated inflation dynamics, which has given the hawks at the ECB the upper hand. This underestimation of inflation dynamics is not over yet. In March, ECB staff had expected inflation to come in at 5.6% year-on-year in the second quarter of 2022. The April and May numbers came in at an average of 7.8%. No need to say more. Back in the good old days, the ECB was actually a bad predictor of future inflation. Remember that back then, the ECB often projected inflation to pick up over the medium term, which it never did. The price of permanently overestimating inflation dynamics was 'lower for longer'. Now, the price for permanently underestimating inflation dynamics will be normalising monetary policy quickly.

Why not hike rates next week?

With the permanent underestimation of inflation dynamics, headline and core inflation still on the rise, and 2024 inflation very close to the ECB's definition of price stability, the only real question is why not hike interest rates next week. In fact, since the start of the year, ECB meetings and press conferences have always surprised to the hawkish side. At the current juncture and given the latest comments, the only way to surprise to the hawkish side once again would be to actually hike rates next week. And in all honesty, the case for such a move is very clear. The only argument against not hiking is the ECB's own 'sequencing', ie first, stop net asset purchases before hiking rates. A rate hike next week would undermine the ECB's credibility and forward guidance. The only reason for not hiking rates next week is because of the ECB maintaining its own reputation or better the choice between keeping up the belief in reliable forward guidance and the credibility as a ruthless inflation fighter.

A rate hike next week is still close to impossible, but we cannot rule out another hawkish surprise. Following the logic of the ECB, this hawkish surprise would be to weaken Lane and Lagarde's de facto pre-commitment and keep a 50bp rate hike on the table for July.

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