Lagarde pre-announces another ECB rate hike for July

The European Central Bank President, Christine Lagarde, is keeping the door wide open for more interest rate rises this summer and has been explaining her decision to raise eurozone rates again by 25 basis points today

ECB President, Christine Lagarde, eyes up another reporter at the central bank's news conference this Thursday

One month before the first anniversary of what's become the European Central Bank's most aggressive tightening cycle on record, the ECB is continuing its fight against inflation and hiked its policy rate by 25bp. The deposit rate is now at 3.5%. A year ago, it stood at -0.5%. The ECB also made official what it had already announced at the May meeting; the reinvestments of bond purchases made under the Asset Purchase Programme will stop next month.

Upward revision to inflation forecast supports more rate hikes to come

Despite a recent softening, actual headline and core inflation remain too high. With expectations for inflation to return to target only in two years' time, there are clear arguments for the ECB to continue raising rates. The fact that the bank's newest staff projections include an upward revision of both headline and core inflation across the entire time horizon must have strengthened the case for continued hiking.

In its latest macro projections, ECB staff now expect headline inflation to come in at 5.4% this year, 3% in 2024 and 2.2% in 2025. Core inflation is expected to come in at 5.1%, 3% and 2.3%, respectively. Remember that in its review of its monetary policy strategy, the ECB stated that inflation returning to target at the end of the forecast horizon was not sufficient or in line with price stability.

> *The ECB had not even thought about a potential pause in its hiking cycle*

Interestingly, ECB staff remain one of the last growth optimists standing. GDP growth in the eurozone is expected to come in at 0.9%, 1.5% and 1.6%, respectively, up to 2025, slightly lower than in the March forecasts. The downward revision, however, seems to be the result of the weaker-than-previously-expected start to the year rather than the result of a change in the fundamental assessment. This is somewhat striking, given that ECB staff still seems to expect eurozone growth to return to potential growth in every single quarter before the end of the year.

During the news conference, President Christine Lagarde somewhat deviated from the recent ECB strategy to stop forward guidance and have a meeting-by-meeting approach as she pre-announced a rate hike for the next ECB meeting in July. Lagarde repeated the earlier phrase that the ECB had "more ground to cover" but added that a rate hike in July was very likely. Lagarde also remarked that the ECB had not even thought about a potential pause in its hiking cycle.

ECB at risk of going too far

Still, and even if Christine Lagarde tried to paint a different picture, with the Federal Reserve's hawkish pause and a eurozone economy not only turning out to be less resilient than anticipated but also facing a very subdued growth outlook, the ECB is increasingly taking the risk of worsening the economic outlook. Also, historical evidence suggests that core inflation normally lags headline inflation while services inflation lags that of goods. These are two strong arguments for a further slowing of core inflation in the second half of the year.

However, as much as arguments against further rate hikes are getting stronger, the ECB simply cannot afford to be wrong about inflation. The Bank wants and has to be sure that it has slayed the inflation dragon before considering a policy change. This is why they are putting more than usual emphasis on actual inflation developments.

While such a strategy supports the ECB's credibility, by definition, it runs the risk of falling behind the curve. Given the time lags with which monetary policy operates and affects the economy, central banks should be forward-looking, not now-looking. This is the theory. In practice, however, the ECB will not change its tightening stance until core inflation shows clear signs of a turning point.

We won't be seeing that at the July meeting, and probably not in the September one, either. In fact, we think it would require an economic earthquake for the European Central Bank not to hike in September as well.

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