ECB hikes policy rates by 25bp

The European Central Bank continues its hiking cycle and shows no sign of pausing any time soon

ECB President Christine Lagarde

One month ahead of the first anniversary of what has become the ECB's most aggressive tightening cycle on record, the central bank continued 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%.

Despite a recent softening, actual headline and core inflation remain too high and with expectations for inflation to return to target only in two years from now, there were clear arguments for the ECB to continue raising rates. The fact that the ECB'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. Still, 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.

Still, despite good arguments against further rate hikes, the ECB simply cannot afford to be wrong on 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. Even if this completely contradicts forward-looking monetary policy, the ECB is in no position to take a chance. This is why we will be listening carefully to what ECB President Christine Lagarde has to say at the press conference starting at 2.45pm CET. It looks as if the ECB remains one of the last growth optimists standing, expecting eurozone growth to return to potential before year-end. This keeps the door for further rate hikes wide open.

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