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ECB is gradually shifting towards a September rate hike

The minutes of the ECB's July meeting suggest that the ECB is still struggling with how to react to a textbook supply-side shock. However, the number of ECB members supportive of a September rate hike seems to be high

ECB President Christine Lagarde at the central bank's press conference last month

At its July meeting, the ECB left interest rates unchanged. Nevertheless, President Christine Lagarde revealed that some ECB members had argued in favour of a rate hike, even though they ultimately backed the decision to stay on hold. That was an important signal that the ECB was edging closer to further tightening. The just-released minutes of the July meeting not only shed more light on that debate but, together with recent macroeconomic developments, strengthen the case for a September rate hike.

Here are the most important statements from the minutes:

- Still high uncertainty but growing awareness of resilience. "Against this background, members assessed that the outlook for activity remained surrounded by high uncertainty. Incoming information had been better than expected, and downside risks to growth were judged to have become less pronounced, as confidence indicators had continued to recover."

- Inflation risks still tilted to the upside. “The incoming data since the June meeting were seen as containing both reassuring elements and reasons for continued vigilance and caution, although the risks to inflation remained to the upside.”
- Gas prices could become the next price shock. “It was noted that one of the reasons gas prices had such an inflationary impact in 2022, aside from their larger increase than in the current situation, was the role of gas as the marginal factor for electricity production at that time.”
- Still no signs of a second-round effect from higher energy prices. “Members noted that underlying price pressures had continued to moderate and that more persistent inflation components had evolved more favourably than expected… Members also considered that the easing in services inflation could be a sign that indirect effects in the travel sector had not materialised to the extent expected. This might be evidence of resistance to price increases, as airlines had faced a reduction in demand when attempting to raise prices… Overall, moderating wage growth, anchored medium and longer-term inflation expectations, stable profit margins and the limited scale of the impact of fiscal policy on aggregate demand supported the assessment that second-round effects of energy price shocks had not yet become embedded in domestic price and wage dynamics.”
- And no evidence of a de-anchoring of inflation expectations. “Inflation expectations were assessed as anchored over longer horizons.”
- Arguments against rate hikes. “Moreover, there had been little evidence of second-round effects materialising. Since staff analysis attributed the increase in inflation so far almost entirely to energy supply developments, with virtually no contribution from aggregate demand or fiscal policy, unlike in the case of the 2021-22 inflation surge, it was argued that a rate increase would not address the underlying cause of the rise in inflation.”
- Not everyone agreed. “Some members noted that, as the incoming data since the June Governing Council meeting had underlined the case for further policy tightening, they would not have opposed raising rates at the current meeting…These members stressed the low likelihood of a situation in which a further rate hike would not be warranted….There was some evidence that acting earlier could at times be less costly and lowered the risk of falling behind the curve. However, under the current circumstances of a fragile, albeit not acute, situation, with the economy close to the June baseline outlook, the most prudent course of action was to move slowly, reflecting the option value of waiting to see how the situation evolved over the summer before considering any further policy steps.”

All in all, the minutes of the July meeting suggest that the discussion on the ECB’s precise reaction function is taking place behind closed doors. It seems as though there is a growing number of ECB members who at least favour the concept of another pre-emptive rate hike.

Moving towards a September hike

Two weeks from now, the ECB will meet again, and the stage looks increasingly set for another rate hike. Not only because some ECB members actually advocated for a rate hike at the July meeting, but since the July meeting, the eurozone economy has shown an almost unexpected resilience to the war in the Middle East, partly due to good luck and the fact that Asian competitors were hit harder by the closure of the Strait of Hormuz and lost orders to European competitors, but also due to long announced fiscal stimulus.

At the same time, headline inflation has continued to edge higher. With oil prices remaining elevated and the risk of a fresh gas price shock increasing, most ECB policymakers are likely to see the case for another rate hike. Isabel Schnabel's recent comments to *Bloomberg* point in the same direction.

Even if the ECB doesn't like the term, the second rate hike this year would also fall into the category of 'insurance rate hike', or maybe more to the ECB's liking: a rate hike to strengthen the ECB's credibility and to preempt any possible indirect or even second-round effects from the current energy price shock.

Whether the ECB will really go beyond a September rate hike is a completely different story. With one additional rate hike, the deposit rate would still be within the range the ECB itself calls neutral. Going further would mean that the ECB sees restrictive monetary policy as necessary. But there is a big difference between an economy that has shown resilience and an overheating economy that needs restrictive monetary policy. We still find it hard to see that in times of public finance woes and surging bond yields, the ECB would really be willing to pour more oil into the fire. Or in other words, it is hard to see that the ECB would be willing to risk a recession to tackle what is still a textbook supply-side shock.

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