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The ECB on the home stretch

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Unity and clear communication becomes even more important now

The ECB delivered once again yesterday, raising interest rates by another 0.25%. So far, so predictable. But the next decisions are likely to be more controversial. For the first time since the start of the hiking cycle, the risk of tightening monetary policy too much is higher than the risk of doing too little.

Progress in fighting inflation can no longer be ignored. Even food prices, most recently the main drivers of inflation, are stabilizing. Energy prices are already exerting deflationary pressure. Credit expansion has stalled and the money supply is shrinking. The Eurozone has slid into a technical recession. This will take additional demand and thus further price pressure out of the system. Even stubborn core inflation has recently shown some signs of relenting (see chart). At 5.3% it is of course still far too high to cause warm and fuzzy feelings in Frankfurt. But all in all: It's on!

Inflation expectations are also falling, to 4.1% for the next 12 months and 2.5% over a three-year horizon. But that is still above the 2% target mark. At this stage, we cannot dismiss the danger of a price-wage spiral.

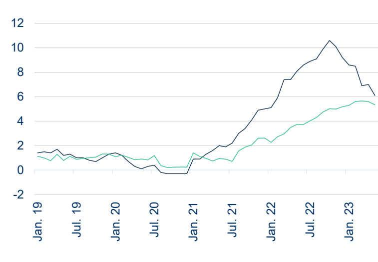
Clear communication to anchor expectations

Now, inflation expectations must once again be re-anchored at the 2% target value to avert a price-wage spiral. To this end, the predictability of monetary policy action will be of even more central importance from now on.

Since Isabelle Schnabel's somersault-forward speech at Jackson Hole last summer, the ECB has regained its credibility thanks to persistent interest rate increases.

The risk of an overly restrictive interest rate policy is on the rise

Eurozone inflation rate (Jan. 2019-May 2023), in %



Source: Eurostat

It would be a shame to put this regained credibility at risk through an unforced misstep. And talking about "wait and see" or "pausing" rate hikes would be such a mistake. If the central bank leaves it open whether the next interest rate step will be up or down, it signals a lack of understanding of inflationary dynamics. That in itself would not inspire confidence. But it would also encourage governors of the Eurosystem's national central banks to liberally float their own interpretations through the press. Contradictory pronouncements are then inevitable. Such cacophony will foster disgruntlement among ECB policymakers and uncertainty in the markets. Just as it did in the acrimonious final phase of the Draghi era.

The ECB should not take a break. It should finish the job.

Bringing the hiking journey to an end without a pause

Therefore, the ECB should not “pause”. When in doubt, it would be better to make one additional rate move on top of the final one in the summer that is currently priced in and then proclaim with confidence: "We are done!" After a hiking journey of 400 basis points since last July, another 25 bp more or less is little more than a rounding error anyway. But uncertainty about the direction of interest rates costs trust. The ECB itself has had to experience this painfully. Trichet's inadvisable interest rate hikes in 2011, just before the outbreak of the Euro debt crisis, is still haunting the ECB today

A pause in interest rates could be understood as a lack of orientation

Yes, Australia and Canada had recently hit the pause button on rate hikes and then continues raising rates after all. But those cases are hardly comparable with the Euro area: For one thing, they do not manage a world reserve currency like the ECB. Most importantly, they also do not have to contend with such a large number of opinionated and potentially fractious national central bankers, who make coherent communication difficult. So, ECB: Continue or stop. But please do not "pause".