ECB MEETING OF 9 JUNE: PREPARING FOR LIFT-OFF – TOWARDS NEUTRALITY OR BEYOND?

At its 10 March meeting, the ECB paved the way for raising its key deposit rate, although the timing of the first rate increase remained uncertain at the time: the odds of a September move had declined compared to a few weeks ago and July was excluded, which left December. The wait-and-see approach still seemed appropriate given the increasing downside risks to growth, aggravated by the current inflationary shock, the war in Ukraine and China's zero-Covid strategy. Yet economic data reported in the meantime, as well as the hawkish tone of several ECB members, seems to have accelerated the tempo.

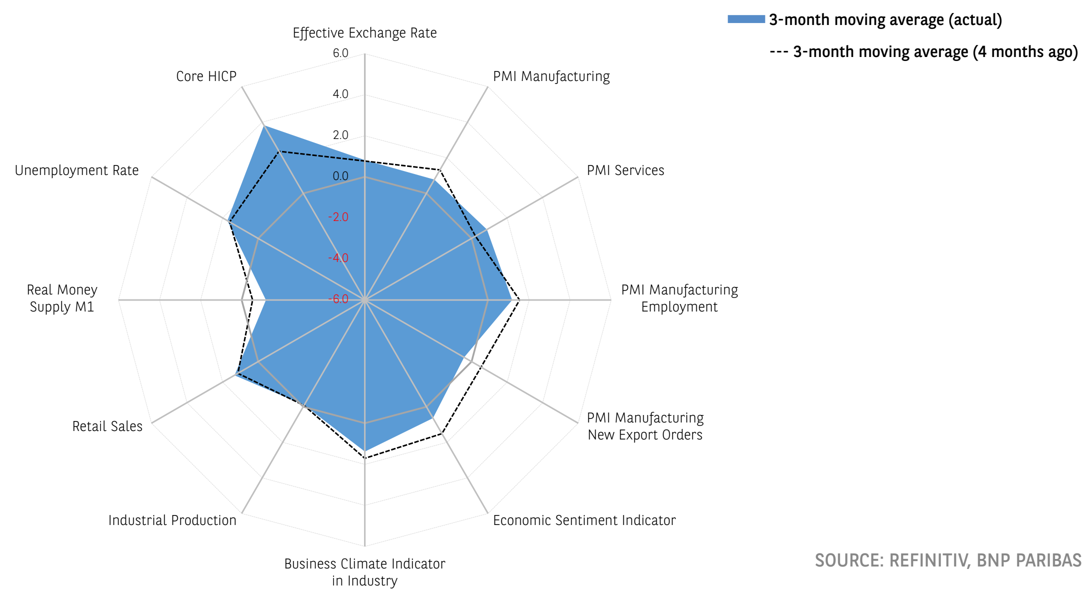
Concerning data, it is the combination of high inflation, a weak euro and relatively resilient growth that has moved forward the lift-off date. Inflation continues to gather steam. According to the Eurostat flash estimate, headline inflation was 8.1% year-on-year in May (0.7 points higher than in April), and core inflation was 3.8% (0.3 points higher than in April). Prices of manufactured goods were up 4.2% year-on-year, while services prices were up 3.5%. About 50% of inflation is still due to the energy component and 20% to the food component. Nearly 70% of the components of the HICP reported year-on-year increases of more than 2% in April. And all Eurozone member countries reported accelerating prices, with the notable exception of the Netherlands. As to the euro, it has been weakened by the monetary policy gap between the two sides of the Atlantic: over the past year, since the single currency resumed depreciating, the EUR has lost 12% against the USD (the nominal effective exchange rate is down 5%). Around mid-May 2022, the euro seemed to be heading towards parity with the dollar: it depreciated to USD 1.04, the lowest level since mid-December 2016. Although a weak euro is favourable for exports, it is also and most importantly an inopportune source of imported inflation. As to growth, the resilience mentioned above is reflected in business climate surveys (their decline is still limited in scope, although there is reason to fear that it underestimates the negative impact of the inflationary shock) and job market figures (the unemployment rate held steady at 6.8% in April, for the third consecutive month).

In this context, July should mark the lift-off date for the normalisation of ECB monetary policy. In an ECB blog post dated 23 May[1], Christine Lagarde made the unusual move of pre-announcing a decision, which is that the ECB could begin raising its deposit rate at the July meeting. She also said the ECB would be in a position to lift interest rates out of negative territory by the end of the third quarter, thus signalling another rate increase in September. The ECB's new set of forecasts to be released during next week's meeting will reveal the growth and inflation assumptions underlying these statements, i.e. inflation should be much higher and growth much slower, albeit not in an alarming manner[2]. The deposit rate is therefore likely to be raised only a few weeks after the halting of the Asset Purchase Programme (APP), announced for Q3 and which should take place in early July, while the ECB meeting is scheduled for 21 July. In the same blog post, the ECB president argued for a gradual approach, which we understand to mean 25bp rate increases, and not the 50bp increases that some are defending. Now that the calendar for the next several months is clearer, the debate is turning more towards the size of each rate hike. By 2023, the focus will also be on the frequency of rate increases (at each meeting or not) and the terminal rate (return to neutrality or beyond), not to mention the effectiveness of monetary tightening in staving off inflation without hurting growth too much.

Hélène Baudchon

1. Monetary policy normalisation in the euro area (europa.eu)
2. In March, the ECB's inflation forecasts were 5.1% in 2022, 2.1% in 2023 and 1.9% in 2024. Its growth forecasts were 3.7%, 2.8% and 1.6%, respectively.

EUROZONE: QUARTERLY CHANGES



SOURCE: REFINITIV, BNP PARIBAS

The indicators in the radar are all transformed into 'z-scores' (deviations from the long-term average, as standard deviations). These z-scores have mean zero and their values are between -6 and +6. In the radar chart, the blue area shows the actual conditions of economic activity. It is compared with the situation four months earlier (dotted-line). An expansion of the blue area compared to the dotted area signals an increase in the variable.