INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Governing Council meeting, ECB. 09/06/2022

First rate rise to take place in July

The ECB's Governing Council met on 9th June and announced that it will implement its first rate hike in 11 years after its next meeting, which is scheduled for 21st July. Interest rates will be increased from 0% to 0.25%. It also stated that rates could be raised further after its September meeting and that the increase could be more substantial if inflation remains a problem. The ECB also confirmed that the 2019 Asset Purchase Scheme (APS) will be terminated on 1st July. This means that the €20b. worth of assets purchased this month will be the final addition to the ECB's balance sheet. Unlike the Bank of England or the Fed, the ECB does not intend to run off or sell any of these assets for the time being. Assets purchased under the Pandemic Emergency Purchase Programme (PEPP), which expired in March, are scheduled to be reinvested until at least the end of 2024 and those purchased under the APS will be reinvested "for an extended period of time past the date when it starts raising the key ECB interest rates."

Compared with other central banks, the ECB has chosen to take a much gentler approach to tightening monetary policy, even though it now expects inflation to average 6.8% in 2022, 3.5% in 2023 and 2.1% in 2024. These new estimates have been revised upwards since March, but may well still prove to be too low. The annualised quarterly growth rate of broad money (M3) peaked at 21% in May 2020. This may have been a much lower maximum than in the USA, for example, but only in the last two months has the growth of broad money slowed to around 4% - 5%, the level compatible with 2% inflation in an advanced economy with low trend growth. Given that the time lag between broad money growth is normally around 18-24 months, the main indicators point to high inflation into 2024. Overall inflation in the Eurozone rose to a record 8.1% in the year to March and producer prices continue to soar – rising by a remarkable 37.2% in the same period. Companies cannot absorb production cost increases on this scale and therefore higher consumer prices are likely to follow. As before, some individual Eurozone member states are seeing significantly higher rates of inflation. It has reached no less than 20% in Estonia, for instance.

It remains to be seen whether the ECB will continue to be satisfied that its monetary policy will be able to reduce inflation to its 2% target in a satisfactory timescale. Other central banks are tightening monetary policy more rapidly and drastically even if such action will do little to curtail inflation in the short term. So far, the ECB has stuck with a gentler approach, but if as seems highly likely, inflation continues to rise further, it may change to more aggressive policies, including asset sales and run-offs, which would lead to monetary contraction.

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