

High, or higher, for longer?

Whether or not we will have high, or higher, interest rates for longer is the question the financial markets must consider after the ECB's latest monetary decision.

President Lagarde has been very firm in her assessment of the current inflationary situation, and has clearly indicated that the ECB will do whatever it takes to bring down inflation.

Strong inflation-fighting signal from the ECB

After its meeting on 15 June, Madame Lagarde sent a strong message concerning the ECB's intention to reduce eurozone inflation, even if that means further monetary tightening.

Not only did the ECB increase interest rates by 0.25% at that meeting, it also indicated that more tightening could be expected as inflation was not falling fast enough.

Furthermore, the ECB has decided to cease the reinvestment of principal amounts from its Asset Purchase Program, which will help shrink its balance sheet and drain liquidity from the financial markets.

The hawkish tone was very clear in the ECB's monetary policy statement:

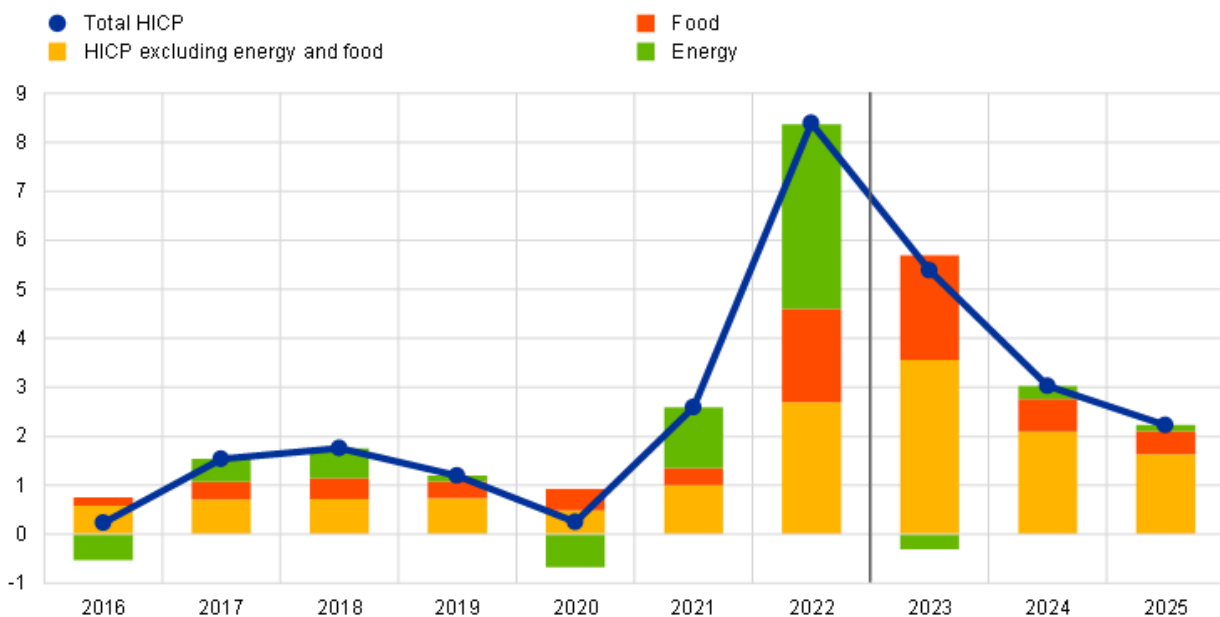
"Upside risks to inflation include potential renewed upward pressures on the costs of energy and food, also related to Russia's war against Ukraine. A lasting rise in inflation expectations above our target, or higher than anticipated increases in wages or profit margins, could also drive inflation higher, including over the medium term. Recent wage agreements in a number of countries have added to the upside risks to inflation"

¹ <https://www.ecb.europa.eu/press/pressconf/shared/pdf/ecb.ds230615~19be62590b.en.pdf>

This view is naturally also reflected in the ECB staff projections for inflation for the coming years (2023-2025).

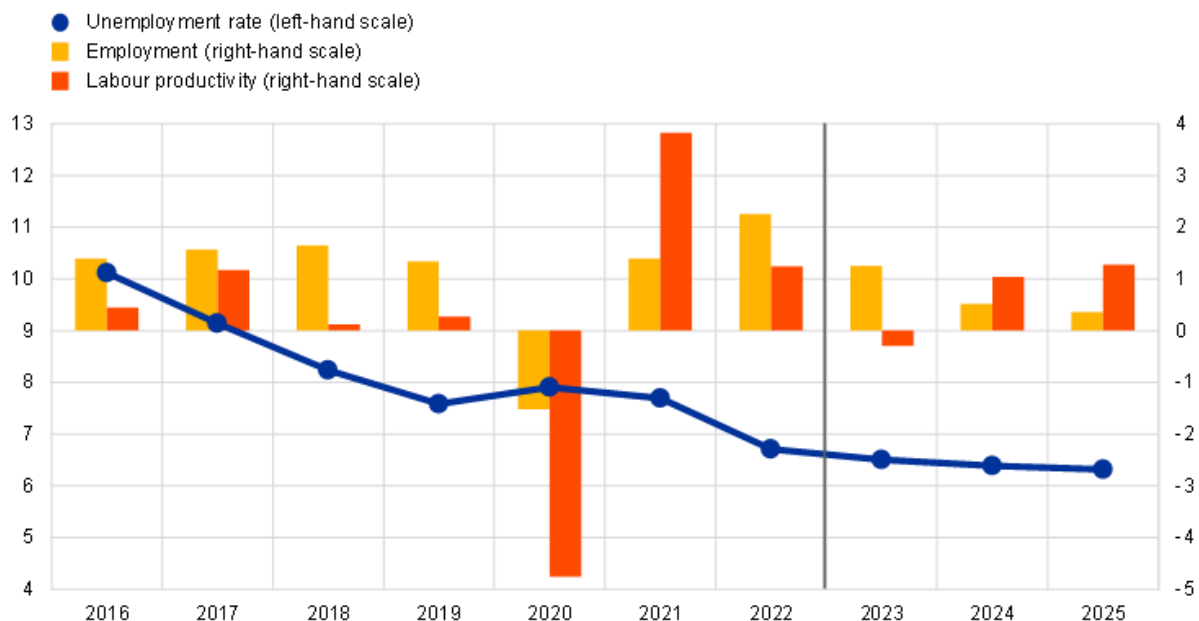
Translating the monetary policy statement into plainer language: we (the ECB) forecast [as seen in Figure 1, below], that food inflation will decline over the next two years, and we also expect that prices for goods and services will fall significantly due to only moderate wage and profit increases; should that not be the case, we will continue to raise interest rates until inflation falls to our target level.

Figure 1 Eurosystem Staff projection Euro area HICP inflation



So how does that correspond with the ECB's labour market forecast?

Figure 2 Eurosystem staff projection eurozone labour market



It is not surprising that Madame Lagarde, and subsequently Isabel Schnabel (German economist and ECB Executive Board member since 2020), indicate that the uncertainty about inflation is heavily biased to the upside.

As the ECB projects real growth of 0.9%-1.6% between 2023 and 2025, the labour market will remain very tight.

Employment is expected to rise each year in the forecasting period, with the unemployment rate continuing to fall to reach the lowest level in ECB history.

With this forecast, however, it is difficult to see how wage compensation could fall to a level that would eliminate the upside risk to inflation.

Higher for longer

Our view, given the recent communication from the ECB, is that we are looking at a scenario in which ECB interest rates will be higher for longer, in combination with the slow and methodical drainage of market liquidity due to the ending of the reinvestment of principal amounts in the ECB's various asset purchase programs.

Summer reflections

The question we will be reflecting on during the coming long and warm summer evenings is quite simple: will the financial markets come to a different conclusion?

For now, we wish you all an enjoyable summer, and will return in August.