Pressure Builds on ECB as Inflation Soars

The cracks on the ECB Governing Council are becoming wider ahead of its key policy meeting on Thursday. No changes in rates are expected at this meeting. However, some Council members are calling for a 50bps hike to be on the table in the third quarter as the ECB starts the process of raising interest rates. Others, though, are calling for rates to rise at a moderate pace, in 25bps steps.

The inflation data for May will unnerve the ECB, with the headline rate soaring to 8.1% from 7.4% in March and April, well ahead of expectations. There is now marked upward pressure on food prices as well as energy costs. Meanwhile, core inflation has been on a pronounced upward trajectory over the past four months. The HICP rate, excluding energy and unprocessed food, has climbed from 2.4% in January to 4.4% by May. This indicates that price pressures are becoming more broadly based in the economy.

It is likely that we are still some months away from the peak in headline inflation. The rise in consumer prices in the euro area during last summer was quite modest. This is unlikely to be the case this summer. Oil prices have surged higher again in the past week after the EU announced a partial ban on oil imports from Russia. This will result in further increases in household fuel and energy prices.

Upward pressure is also likely to be maintained on food prices, amid concerns about global shortages. Thus, inflation in the euro area could easily reach 9% or higher by the end of the summer. This would increase the pressure on the ECB to move interest rates quickly into positive territory. Currently, its key deposit rate is pitched at -0.5%.

Market rate expectations have hardened appreciably in recent weeks. Futures contracts are now pricing in 125bps in rate hikes at the four ECB policy meetings due to be held over the second half of the year, pointing to at least one 50bps hike. This would bring the deposit rate to 0.75% by end year. Further rate hikes are anticipated in 2023, with the market looking for the deposit rate to get to 1.75% by the end of next year.

The sharp rise in inflation, though, will weigh heavily on real disposable income and result in sluggish growth at best in the euro area economy over the second half of this year and well into 2023. We expect to see sharp revisions to the ECB's macro forecasts for 2022 and 2023 that will be published at Thursday's meeting. Inflation projections will be upped significantly and growth cut compared to the last set of projections in March.

Inflation should start to fall appreciably later this year, but it is uncertain how quickly it will return to the 2% target. The sharp rise in inflation is largely being driven by a surge in commodity prices amid disruptions to global supply chains. Further upward pressure on commodity prices cannot be ruled out over the winter if supply/demand imbalances continue to worsen in primary markets. There is also a risk of the recent surge in prices becoming engrained in inflationary expectations and wage setting behaviour.

On the other hand, the likely weak economic backdrop should help inflationary pressures to eventually moderate considerably. Overall, there is a wide margin of error in both directions around market expectations that official rates will be at 1.75% by end 2023, given all these uncertainties.

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