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For now, the ECB is doing everything right

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The next hefty interest rate hike is coming in December

When I read the title of this plain text, I have to pinch myself a bit. Seriously? There's no question about it: the ECB has made serious monetary policy mistakes. For far too long, it clung to the chimera of "transitory inflation." For far too long, it has lazily relied on its economic models, which always joyfully proclaimed that inflation would be back at the 2% target value in two years' time. The Frankfurt panic attack during the summer, which led to the introduction of the so-called transmission protection instrument TPI ("Try and Protect Italy"), has already been sufficiently criticized here.

The ECB is now trying to make up for past failures

That was then. But now the ECB is on the right track. It all but admitted that it had missed the boat and that the reins were pulled much too late. Self-reflection is the midwife of change. And since the summer, the ECB has carried out its policy change with gusto. Yesterday brought another interest rate hike of 75 basis points (to 1.5% for the deposit rate). The second jumbo hike in a row. That's good. It would have been unthinkable just a short time ago.

And there's more to come. For the last meeting of the year, LBBW Research expects another equally large rate hike to then 2.25% for the deposit rate. By spring, we should be at 3%. At that point, monetary policy would be slightly restrictive. That would probably be the end of the hiking cycle for the time being.

The recession will stabilize prices

More aggressive interest rate hikes would be risky

Of course, one can argue that this catch-up action is completely inadequate in view of double-digit inflation rates. In fact, however, an aggressive interest rate hike as in the early 1980s would be highly risky. In Europe, we are on the verge of a recession. In

Germany, we are probably already there. The ECB is now trying to finish normalizing interest rates before the recession is measurable and visible to all.

Restrictive monetary policy combats excessive demand. But excess demand is currently not our problem. On the contrary, business and household confidence is rushing from one all-time low to the next. Demand is plummeting (see figure).

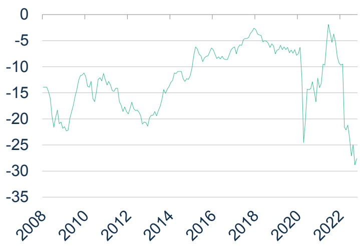
The much feared price-wage spiral remains elusive. In view of full employment and the inflationary shock, the latest settlement in the German chemical industry was moderate, even if it will hurt many of the already beleaguered companies in this energy-intensive sector.

And long-term inflation expectations remain close to the 2% target. Keeping inflation expectations in check is now the most urgent task for the central bank. And so far it has succeeded. That is why it is not advisable at present to tackle inflation, which is still largely a supply-side phenomenon, with a hyper-aggressive interest rate hikes. That would deepen the recession and increase the risks to financial market stability. It would also encourage increasingly critical member governments to more fundamentally question the independence of monetary authorities.

The Frankfurt truce is fragile

By the beginning of 2023 at the latest, the relative harmony in the central bank council should be over. At present, no one is questioning the interest rate hikes. But since inflation will probably not peak until the spring, the hawks will call for further interest rate steps. Possibly also the start of the sale of the accumulated portfolio of government bonds ("quantitative tightening"). Policymaking will become more conflictive and communication more cacophonous. Market volatility will perk up.

Consumer Confidence in the Euro Area



Source: Refinitiv, LBBW Research

A price-wage spiral remains elusive