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The ECB faces up to reality

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Isabel Schnabel talks tough in Jackson Hole. Now walk the talk!

At the annual meeting of central-bank elites in Jackson Hole, Wyoming, particular attention was paid to Fed Chairman Jerome Powell's brief and hawkish speech. He made it as clear as possible that the U.S. central bank will accept a recession if that were the price to fight inflation.

Is the ECB waking up from its slumber?

Less noticed, but at least as important for Europe, was the performance of the ECB. Christine Lagarde was not present herself, which is a little odd in itself. In her place Isabel Schnabel, the German member of the Executive Board, gave a remarkable speech. Schnabel is increasingly regarded as the most influential member of the ECB's top brass, since the central bank's chief economist, Philip Lane, has lost some credibility by having stubbornly insisted on the dovish "transitory inflation" thesis.

Isabel Schnabel's most important points for the ECB reset:

- Inflation expectations are about to take on a life of their own. The credibility of central banks is at risk.
- Monetary policy that is too hesitant may end up increasing the real economic costs of fighting inflation.
- To recapture inflation expectations, policy rates must rise more strongly than inflation expectations.
- A central bank must not let up in the fight against inflation as long as inflation expectations are too high.

Despite a looming recession, the ECB will have to raise interest rates significantly

Schnabel's speech advocating a robust policy response might arguably be interpreted as the foundation of a new beginning in the ECB's monetary-policy stance. A "big rate hike" of 75 basis points at the ECB Governing Council meeting next Thursday now seems increasingly likely. The hawks have the upper hand.

The ECB's starting position is exceptionally bad. Exploding gas and electricity prices are further fueling inflation in the euro area.

At the same time, the energy crisis is plunging Europe into recession. For Germany, LBBW Research forecasts the economy to contract by 1% in the upcoming year, and only a little better for the Euro area overall.

The fact that the ECB will nevertheless have to raise interest rates, and presumably faster and further than the markets had recently expected, is likely to put additional downward pressure on the real economy this year and next. A considerable loss of purchasing power as well as redistributive effects of both the recession and the energy crisis threaten to undermine the social consensus in Europe.

The ECB has made life unnecessarily difficult for itself

At the same time, things are getting more challenging for debtors. Quite naturally, all eyes here are once more on Italy. To make matters worse, the country is embroiled in a self-inflicted election campaign. Speculation against Italian government bonds is picking up speed, Italian yields are touching 4% again.

The ECB has virtually encouraged investors to test the ECB's comfort zone by introducing a so-called "transmission protection instrument" (TPI). I have pointed out the dangers of this ill-conceived instrument previously.

To be sure, it would be unreasonable to blame the ECB for everything. The current inflation is, in the first place, the result of external shocks such as the pandemic, supply chain chaos, war, and energy supply constraints. But by adopting an excessive wait-and-see approach, the ECB has made matters worse. Everyone in the Euro area will suffer the consequences.

Euro area inflation and ECB policy rates

Source: Refinitiv

By adopting an excessive wait-and-see approach, the ECB has made matters worse