European Central Bank paints bleak picture of economy

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The European Central Bank decided to maintain its present ultra-low interest rate policy at its meeting last Thursday and sought to create the impression in its monetary policy statement that it had the increasingly turbulent economic and financial situation in the eurozone under control.

But the statement painted a bleak picture of the eurozone economy and the question-and-answer session with ECB President Christine Lagarde underscored that the central bank has no real idea on how to chart increasingly turbulent waters.

The ECB resisted pressure at the meeting to follow the lead of the US Federal Reserve, the Bank of England, as well as a number of other central banks, to lift interest rates in response to the global surge in inflation.

In her opening press conference statement Lagarde said the Ukraine war and the associated uncertainty was “weighing heavily on the confidence of businesses and consumers.”

“Surging energy and commodity prices are reducing demand and holding back production. How the economy develops will crucially depend on how the conflict evolves, on the impact of current sanctions [against Russia] and on possible further measures.”

Throughout most of last year the ECB maintained, along with the Fed, that inflation was “transitory.” That perspective has now been junked as Lagarde warned that inflation had increased “significantly” and would “remain high over the coming months, mainly because of the sharp rise in energy costs” with inflationary pressures intensifying “across many sectors.”

Growth was weak in the first quarter of this year and there would be “slow growth” in the period ahead both because of the uncertainty created by the war and the continued disruption to supply chains because of the ongoing COVID-19 pandemic.

Lagarde noted that inflation in the eurozone had increased to 7.5 percent in March, up from 5.9 percent in February, and energy prices were now 45 percent higher than a year ago.

While the struggle by workers for wage increases in the eurozone still remains relatively subdued, that could change very quickly, as evidenced by the recent two-day strike in Greece.

Lagarde indicated that, like other central bankers, her eyes are firmly fixed on wages, saying “higher than anticipated wage rises” were an upside risk to inflation, together with a “worsening of supply-side conditions.”

In response to a question, she insisted the ECB would not move to lift interest rates until asset purchases by the bank were concluded sometime in the third quarter and that it would “deal with interest rates when we get there.”

One of the major factors affecting the ECB’s interest rate stand is the effect of a rise on the more indebted countries, such as Italy, with any increase exacerbating their financial problems.

A questioner from a German news organisation referred to the issue of “fragmentation”—a situation in which interest rates in Italy and other southern European countries begin to diverge markedly from those in northern countries.

The questioner then raised the issue of a wage-price spiral. “How far is the governing council worried about a wage-price spiral with inflation getting out of control? You have mentioned wages, and wage growth is muted but it is coming. We are in Germany, and I think we may be in for a hot autumn.”

The use of the term “hot autumn” was significant because it recalled the situation in the late 1960s and early 1970s when the struggles of the working class for

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wage rises unleashed by the last inflationary surge destabilised governments—the spectre that haunts the ruling class today.

On the issue of "fragmentation," Lagarde offered the assurance that the ECB was prepared to be "flexible."

As for wages and the so-called second round effect on inflation as workers push for increases, Lagarde responded somewhat testily: "I think I have told you at the last press conference we had that we were particularly attentive to wages, and we continue to do so, because that is a critically important component to assess [the] inflation outlook in the medium term."

She returned to the issue in response to another questioner who asked how ending asset purchases in the third quarter was going to reduce inflation.

Dismissing any conception the ECB believed reducing asset purchases would affect the price of oil, she said: "Who would, in their right mind, think so? But it is also, obviously the case that we have to be attentive to the inflation shock, to the impact that it has on wages."

In some countries, she said, unions and management had taken into account the risk of redundancy and the threat to the economy—that is, the unions had been successful, at least so far, in keeping wage demands "relatively muted." But in others, there were much higher wage demands and we will "continually [to] look at that extremely carefully."

Throughout her press conference, Lagarde maintained the ECB was on a path of "normalisation," and it had started a journey that was "moving along as predicted."

Of course, this raised the obvious question of what constituted "normalisation" under conditions of the highest inflation in 40 years, a major supply-shock to the economy, and the impact of the war in Ukraine.

These issues were raised, albeit somewhat obliquely, by a questioner who asked whether the ECB actually had an "idea of what normal is." Lagarde provided no real answer, simply stating that when talking about normalisation of monetary policy "I think of the kind of instruments we are using."

In response to another question, she was somewhat more informative about the real state of affairs in the ECB headquarters. Because of the war there were "major developments that are not predicted, that are not part of past patterns" and "who knows" what would be the impact of the development of the war on the European economies.

There was also something of an extraordinary admission. Given the push to impose a total European embargo on Russian oil and gas imports, one questioner asked whether there had been any consideration by the ECB about the potential impact of such a move.

She acknowledged that an abrupt boycott of oil and gas would have a "significant impact" but then continued: "But have we actually factored in exactly the net amount, the trade-off resulting from such a boycott? No."

Some forecasts have been made. German chancellor Olaf Scholz said last month that an embargo on Russian oil and gas supplies "would mean plunging our country and the whole of Europe into a recession. Hundreds of thousands of jobs would be at risk. Entire branches of industry are on the brink."

This assessment was endorsed by a forecast by five German economic institutes last week. It said a full embargo would trigger a major recession in Germany, result in a 2.2 percent fall in output and wipe out more than 400,000 jobs. The report said a full embargo, after slowing growth this year, would lead to a contraction of 2.2 percent in 2023 with the cumulative impact over two years greater than that of the pandemic.

Supporting Scholz's comments on the effect of an embargo, the BDI, a major German business lobby group, said it would have "incalculable consequences," including production disruptions, employment losses and "massive damage to production facilities" in some cases.

BDI president Sigfried Russwurm warned the European Union was not prepared for such a move. It would "jeopardise [EU] unity and [its] ability to act economically and politically" and a total boycott would "tear the EU apart."

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