European Central Bank to make crucial interest rate decision

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The eyes of the financial world today are firmly fixed on Europe as the European Central Bank meets to decide how much to lift its base interest rate.

At the same time, there have been concerns over whether Russia would fully restore gas supplies to Germany, the euro zone's largest economy following the closure of the Nord Stream 1 gas pipeline for maintenance. At this point it seems likely the gas flow will resume but there are no guarantees for the future.

ECB president Christine Lagarde has said the central bank will lift its base interest rate by 0.25 percentage points (25 basis points) in a gradual move back to the "normalisation" of monetary policy following years of negative rates.

The ECB then pumped hundreds of billions of euros into the financial system.

The crisis was sparked by so-called fragmentation as the interest rates on the government bonds in the more indebted southern countries diverged from those issued by the stronger economies in the north, threatening the stability of banks and the governments that stood behind them.

Fragmentation is again a threat, and the ECB is set to announce a new scheme to buy bonds which it dubs a transmission protection mechanism at today's meeting. The central bank is grappling with a situation that goes well beyond the problems it faced a decade ago, due to the escalation of inflation, which now hit 8.6 percent across the euro zone.

But this overall figure hides the worsening inflationary situation in a number of countries in the 19-member bloc.

In nine of the member countries inflation has already hit double digit levels and in the Baltic countries it is almost 20 percent. The inflation situation has been worsened by the fall of the euro against the dollar—at one stage last week it went below parity – which is pushing up the price of imports.

Worsening inflation numbers have prompted calls that the interest rate hike must be 50 basis points and that the 25-basis point rise foreshadowed by the ECB at the last meeting of its governing council, with the possibility of a further increase in September depending on inflation numbers, is too slow and too late.

A "more hawkish" member was cited anonymously by the *Financial Times* (FT) as saying: "It is like antibiotics, it doesn't help if you take them in September if you are ill now. Interest rates are our medicine and the timing and size of the dosage are of utmost importance."

The so-called "fragmentation" problem is an expression of the fundamental contradiction that lies at the very centre of the euro zone—that is, the integrated character of production and finance across the continent, and the division of Europe into nation states.

The ECB sets financial conditions across the euro zone but each of the 19-members has its own government and fiscal policy.

On top of this there is growing political instability. The government of Italian president Mario Draghi basically collapsed earlier this month when the Five Star Movement, anxious to hold on to its electoral standing, withdrew its support saying not enough was being done to offer protection for the population against rising inflation.

If a new government cannot be cobbled together, and if elections are called, this will raise concerns in financial markets about the capacity of Italy to finance its government debt, now running at more than 150 percent of gross domestic product (GDP).

There is also political instability in France following the failure of President Macron to win a parliamentary

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majority at the elections last month.

And hanging over the ECB decision is the uncertainty over gas supplies that could be cut or significantly reduced at some point in retaliation for the sanctions imposed by the European powers as part of the NATO proxy war in the Ukraine.

In remarks to the FT, Petr Cingr, the chief executive of Germany's largest ammonia producing company, and a key supplier of fertilisers and exhaust fluids for diesel engines, warned of the devastating consequences of the ending of Russian gas supplies.

"We have to stop [production] immediately," he said, "from 100 to zero."

If gas cannot be stored for the winter months, Germany will experience a major economic contraction.

According to UBS analysts, no gas for the winter will result in a "deep recession" with GDP contracting 6 percent by the end of next year. Problems are already appearing. German economic growth has always been export dependent but the latest data have revealed that its balance of trade has turned negative.

It has been estimated that the rising price of food and energy will deliver a negative blow of €400 billion to the euro zone's balance of trade this year.

Germany's Bundesbank has warned that the effects on global supply chains of any Russian cut-off would "increase the original shock effect" by two and a half times.

ThyssenKrupp, Germany's largest steelmaker, has said that without natural gas to run its furnaces "shutdowns and technical damage to our facilities cannot be ruled out."

Other major companies, including BASF the world's largest chemical company, have warned of similar effects.

Continuity of supply is not the only issue. The question of price also looms large. Natural gas prices have increased eight-fold in the past 18 months rising from €20 per megawatt hour to €160, with the price doubling over the past month. Many companies have said they cannot operate with prices at this level.

The deputy head of the Brussels-based Bruegel economic think tank, Maria Demertzis, told the FT, there was an "almost impossible situation."

"The risk ahead of us is that because of the energy crisis, the euro area could end up in recession, while at the same time the ECB will have to keep raising rates if inflation does not come down."

Albert Ludwigs, an economics professor at the University of Freiburg and an adviser to the German finance minister, has said policymakers face a "nightmare scenario."

"It is more difficult than in the 2012 debt crisis, when we have a clear choice between monetary policy or fiscal policy solutions, but now both are much less clear."

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