European Central Bank announces another big interest rate hike as recession trends strengthen

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The European Central Bank (ECB) has announced a major increase in its base interest rate for the third consecutive time, despite acknowledging that the euro zone is on the way to recession.

The increase of 75 basis points was in line with market expectations as the ECB said it expected to raise interest rates further.

Outlining the economic situation at her press conference following the meeting of the governing council yesterday, ECB President Christine Lagarde pointed to worsening conditions on several fronts.

"Economic activity in the euro area is likely to have slowed significantly in the third quarter of the year and we expect a further weakening in the remainder of this year and the beginning of next year," she said.

High inflation, currently running at close to 10 percent, was reducing people's real incomes, pushing up costs for firms and dampening spending and production, with both business and consumer confidence falling "rapidly."

"Demand for services is slowing, after a strong performance in previous quarters when those sectors most affected by the pandemic-related restrictions reopened, and survey-based indicators for new orders in the manufacturing sector are falling," Lagarde stated.

In addition, worsening terms of trade—the result of the rise in the value of the US dollar against the euro, which is driving up the price of imports faster than the higher prices received for exports—was also "weighing on incomes in the euro area."

According to the ECB, inflation in energy prices was 40.7 percent over the last year. But Lagarde made it clear the central bank is not in favour of increased government spending to try to counter the effects of the price hikes.

"Fiscal support measures to shield the economy from the impact of high energy prices should be temporary and targeted at the most vulnerable," she said, adding that governments should pursue policies aimed at bringing down high public debt ratios.

In response to the warnings of recession, the view was expressed in some quarters that the ECB may be easing back on rate increases. The head of macro research at the Dutch bank ING, Carsten Brzeski, told the *Financial Times* Lagarde's emphasis on recession "opened the door to a dovish plot."

But given the attitude of the members of the central bank's governing council, as revealed in the minutes of its September meeting, this may be wishful thinking on the part of finance capital, always keen to get its hands on cheaper money.

The meeting minutes noted that inflation was becoming "self-reinforcing, to the point that even a projected weakening of growth was not sufficient to bring inflation back to target."

As with central banks around the world, the key concern of the ECB is that inflation drives workers into wages struggles and they break out of the constraints of the trade union apparatuses as it becomes ever more apparent that price hikes are going to continue.

"The longer inflation persisted, the higher the risk that inflation expectations could become unanchored and the costlier it would be to bring them back to target," the minutes said.

Expressing the ECB's willingness to induce a recession, if that is what proves necessary to suppress wages struggles, the minutes stated that "growth concerns should… not prevent needed forceful increases in interest rates."

The higher interest rate regime is starting to throw up divisions in the euro zone.

On Tuesday, the newly installed Italian prime minister, Giorgia Meloni, leader of the fascist Fratelli d'Italia, used her first speech in parliament to take issue with the ECB's tighter interest rate and monetary policy regime.

She said the decision to raise rates was "considered by many to be a rash choice, which runs the risk of impacting banking credit to businesses and families." It was compounded by the ECB decision in July to end its bond-buying program, which "creates further difficulties for member states that have elevated public debt."

The ECB decision to start lifting rates, taken at its July meeting, was accompanied by the launch of a new program, the Transmission Protection Initiative (TPI), which allows the central bank to buy up the bonds of highly indebted countries, Italy in particular, to prevent a bond-market selloff and escalating interest rates.

But the TPI requires that governments comply with ECB dictated "restructuring" measures which Meloni and her party opposed under former Prime Minister Mario Draghi and which in part boosted its electoral support.

Meloni is not the only critical voice. In an interview with the newspaper *Les Echos* last week, French president Emmanuel Macron warned against suppressing demand.

"I'm concerned to see lots of experts and certain European monetary policymakers explain to us that we need to break demand in Europe to better contain inflation," he said. "One must be very careful."

Macron did not specify what "policymakers" he was referring to, but the push for higher rates is largely being driven by German financial authorities.

Earlier this month, criticism of central bank policy was the subject of a tweet by Finnish Prime Minister Sanna Marin. She said something was "seriously wrong with the prevailing ideas of monetary policy, when central banks protect their credibility by driving economies into recession."

These criticisms were raised in a question to Lagarde at her press conference. She gave them short shrift, saying "we have to do what we have to do." Lagarde said the ECB was not oblivious to the "risk of recession," but, based on its mandate, had to deal with the "reality of inflation."

The ECB had to address another issue with political consequences. As part of its policies to bail out corporations with the onset of the pandemic, it provided €2.1 trillion in ultra-cheap loans, known as targeted longer term refinancing operations.

But with the rise in the bank's interest rate this raised the possibility that borrowers could deposit that money with the ECB and pick up $28 billion in risk-free profit, according to estimates by the US bank Morgan Stanley.

To counter what were characterised by one finance executive as "bad optics"—a massive handout to financial concerns as households were hit with a "historical shock" to their incomes—the ECB decided to raise the interest rate on the loans from November 23 to bring them in line with its base rate.

But this retroactive decision to change the rules could bring legal action, with some banks warning that it would damage the credibility of ECB refinancing operations.

In the wake of the crisis in the UK, following the Truss government's mini budget of September 23 which saw bond prices collapse, there are concerns that European markets could also be hit with major financial turbulence.

This week the International Capital Market Association, which represents the biggest traders in the bond markets, sent a letter to the ECB warning of problems in the repo market. This is the area of the financial system which provides short-term funding, very often overnight, for banks and provides them with collateral in derivatives trading.

The European repo market is around €10 trillion. The letter said that the shortage of liquidity in this market had previously led to dislocations on a limited number of occasions, such as at the start of the pandemic.

"However, as we enter a new phase of the monetary policy cycle, with the normalization and associated market volatility, the potential for both the scale and frequency of such dislocations is likely to increase," it stated.

The letter said current liquidity conditions in the euro zone repo and money markets raised the concern that "rising dysfunction could imperil the transmission of monetary policy."

As the ECB lifts rates, with the warning that more is to come, such warnings indicate that the crisis that erupted in the UK, while it had certain British characteristics, was rooted in the changes in the global financial system flowing from the higher interest rate and tightening policy regime, which dominates every country and region.