MNI INTERVIEW: September Hike Not Guaranteed – ECB's Demarco

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LONDON – The bigger-than-expected drop in energy prices and encouraging data including a fall in core inflation mean there is no reason for the European Central Bank to rush into any further interest rate increase, Bank of Malta Governor Alexander Demarco told MNI, adding that a hike in September is not guaranteed.

"If both the data which is coming out and the new projections in September continue to show that the baseline or milder scenario still holds, we could have a reason to hike again. But if the actual data shows that things are better than what we expected of indirect effects on inflation, maybe there is no need for another rate hike in the end," he said in an interview on the sidelines of the ECB Forum in Sintra.

"I think time is a bit in our side in the absence of any dramatic developments," he added, though he noted that even the ECB's milder scenario, which now seems to be materialising, implied another rate hike.

"The question is now the timing, because I think, given that oil prices have gone down so much, we have to see what the data will tell us."

Oil prices are now lower than the projections in the milder scenario, though futures prices are still between the mild and baseline scenarios, said Demarco, adding that while cheaper energy could have positive implications for short-term inflation expectations, the U.S.-Iran ceasefire is fragile and uncertainty persists. (See MNI INTERVIEW: ECB Ready To Hike Or Change Course - Kocher)

MILDER SCENARIO DISCUSSION

Demarco admitted that he had initially shared reservations with some other Governing Council members regarding the inclusion of the mild scenario in the ECB's June projections.

"I thought, at that time ... the milder scenario was not very likely to happen," he said, noting that prospects for rapid agreement between the U.S. and Iran had appeared remote during the June meeting. However, he added, "I saw the rationale also for including the milder scenario because ... even though it may have seemed less probable to occur ... it would confirm the need for the rate hike in June ... So from that perspective, I went along with the decision and I think it was a good decision to include the mild scenario."

CORE INFLATION KEY

For Demarco, the most important signal in recent inflation releases came from the fall in the core gauge, which he took as a sign that higher energy costs are not feeding through broadly into the economy more than expected.

“Core inflation, even though we do not target core inflation per se, is a very good indicator where inflation is heading,” he said, noting that headline readings can be distorted by temporary movements in energy prices due to tax measures.

“You could have oil prices falling sharply, and that will be definitely a strong negative effect on overall HICP. But if you have core inflation rising, and maybe the drop in energy prices temporarily offsetting that, you could think that inflation has gone down. But the dynamics would be still worrying in that respect,” he said.

“Core can be the change of dynamic to see, like, things are starting to improve.”

AI, R* AND EXCHANGE RATE

The ECB has slightly raised its estimate of the neutral rate, but Demarco was cautious as to any suggestion that this might reflect productivity gains linked to artificial intelligence.

“I'm not too sure that it's really AI pushing up this,” he said, arguing that cyclical factors linked to the energy shock and higher defence spending may be playing a bigger role. Policymakers should wait until the effects of the latest shock dissipate before drawing conclusions about the long-term implications for monetary policy and the neutral rate, he added.

Demarco said recent euro weakness against the dollar was largely irrelevant from a monetary policy perspective. A move from around USD1.16 to USD1.14 was “not a dramatic effect,” he said, attributing most of the adjustment to changing expectations around Federal Reserve policy rather than any deterioration in the euro area outlook.