Top ECB official warns oil shock may force interest rate hikes

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The European Central Bank is edging closer to raising interest rates to prevent the latest oil shock from morphing into a broader inflation spiral, according to one of its more dovish policymakers.

In an interview with POLITICO on Monday, Bank of Malta Governor Alexander Demarco broke with fellow policy doves, who in recent days have urged patience and called for more data before deciding whether tighter policy is needed.

While agreeing that the ECB must remain "data-dependent and meeting-by-meeting," he signalled little optimism about where that data is heading.

"The prospects of looking through this shock appear to be fading now, given the prolongation of the conflict and the prospects of oil prices remaining higher for longer," Demarco said in the Monday interview.

Even a resolution of the war before the ECB's June 11 meeting may not cool energy prices enough for policymakers to stay put, he warned.

"The damage done to the infrastructure is likely to keep energy prices at a higher level than that prevailing before the conflict," he said. Nor would a lasting ceasefire necessarily restore supply routes if, for instance, passage through the Strait of Hormuz remains risky, he said.

"Supply constraints are likely to linger."

Energy shock

It is Europe's second major energy shock in four years. After Russia's invasion of Ukraine in 2022, the ECB initially treated the surge in prices as temporary. Instead, higher energy costs spread through the economy, lifting inflation expectations and wage demands and eventually pushing inflation above 10 percent.

At its April meeting, the ECB left the key deposit rate unchanged at 2 percent, despite headline inflation jumping to 3 percent, as it argued medium-term forecasts still showed price pressures easing toward target. But it signalled a hike may come as early as June.

Determined not to repeat the mistakes of 2022, Demarco said policymakers must stop higher energy costs from feeding into broader inflation and medium-term expectations. While there are no signs yet of inflation expectations surging, he cautioned that it is still early days. "These things don't happen overnight."

Demarco declined to say how many rate hikes might be needed. "We are committed to setting monetary policy to ensure that inflation stabilizes at 2 percent in the medium term. This could require one rate hike. It could require more," he said.

Markets are currently pricing in three ECB rate hikes this year, while most economists expect a milder tightening cycle.

Second hit

The dilemma for the ECB is that raising rates in a supply shock risk delivering a second hit to an already weak economy. Consequently, several policy doves, including Luis de Guindos, François Villeroy de Galhau and Yannis Stournaras, continue to call for restraint and for more data before assessing whether action on rates is needed.

Several prominent economists, including Berenberg chief economist Holger Schmieding and EFG Bank chief economist Stefan Gerlach, argue the ECB should stay patient. "The Iran war and its fallout are hitting the economy hard," Schmieding wrote in an op-ed on Monday. "With growth weak and unemployment rising, workers are unlikely to be able to push through excessive wage demands. Companies, too, will struggle to pass on all additional costs to customers."

Demarco supports ECB forecasts which point to a recession being avoided but acknowledged the risks if the crisis deepens enough to force fuel rationing.

"If we arrive at that point, then there is, of course, a real risk of recession, but at this juncture we are not there," he said.

More broadly, Demarco echoed growing frustration inside the ECB's Governing Council over Europe's failure to push through reforms needed to raise long-term growth.

While Brussels has revived efforts to deepen its capital markets union, progress remains slow and politically contentious — especially on joint sovereign debt issuance, which still faces resistance from fiscally conservative countries.

"Especially on common bonds, I'm not seeing that much progress in this direction," Demarco said. "Things move slowly in Europe," he said, urging governments to streamline EU decision-making and abandon the requirement for unanimity in certain policy areas.