The European Central Bank raises its key rate to 4.00%, leaving the door open to further increases…

According to the European Central Bank:
- The key rate goes up 25 basis points to 4.00%.
- The monetary policy is still on the accommodative side.
- Financing conditions are favourable, money and credit growth is vigorous, and liquidity in the euro zone is ample.
- The conditions are in place for the euro zone to continue expanding at a sustained pace.
- Over the forecast horizon, the risks to price stability are to the upside.

Commentary:
As expected, the European Central Bank raised its key rate to 4.00% this morning. Note that the reintroduction of the concept of vigilance (which is what signalled the previous seven increases) in the statement accompanying May’s decision sent a clear message as to today’s decision.

What remains to be seen is just how far the ECB intends to take its rate hikes. Everything seems to be in position for sustained expansion by the euro zone’s economy. The ECB thus increased its projections for the range of economic growth between 2.3% and 2.9% for 2007, and 1.8% to 2.8% for 2008. Under these circumstances, the ECB judges that, over the medium range, the risks associated with inflation are to the upside. While inflation is currently contained (the annual change in the consumer price index stayed at 1.9% in April), the ECB is still concerned about increased production capacity utilization and the gradually improving job market, which could translate into bigger than expected wage increases.

In our opinion, the door is open for at least one more rate hike. In the ECB’s usual jargon, the use of the words “monitor closely” in the statement suggests that the policy will next be tightened (to 4.25%) only in September. At that time, however, we judge that the ECB’s monetary policy will have moved into neutral. Any other rate hike will therefore depend on how economic conditions evolve. The signals will then be more mixed. The ECB will certainly want to slowly abandon the “code” it has been using since the end of 2005 to keep more leeway in conducting its monetary policy.

The increase, fully priced in by the markets, had little effect on the euro, which is still struggling to appreciate as the likelihood of rate cuts in the United States has dropped substantially.
[...] At today’s meeting, we decided to raise the key ECB interest rates by 25 basis points. This decision was taken in view of the prevailing upside risks to price stability over the medium term that we have identified through both our economic and monetary analyses. Today’s decision will contribute to ensuring that medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability. Such anchoring is a prerequisite for monetary policy to make an ongoing contribution towards fostering sustainable economic growth and job creation in the euro area. After today’s increase, given the positive economic environment in the euro area, our monetary policy is still on the accommodative side, with overall financing conditions favourable, money and credit growth vigorous, and liquidity in the euro area ample. Looking ahead, acting in a firm and timely manner to ensure price stability in the medium term is warranted. The Governing Council will monitor closely all developments to ensure that risks to price stability over the medium term do not materialise. [...]