LBBW Bereit für Neues

To the point!

Cross-Asset- and Strategy-Research

Inching towards monetary easing

Moritz Kraemer -- Chief Economist
LBBWResearch@LBBW.de

January 26, 2024

First ECB rate cut is likely in June

On Thursday, the ECB once again left interest rates unchanged. The rate at which interest is paid on deposits at the central bank therefore remains at 4%. In itself, this is only worth a yawn. Almost all economists had expected this. Including LBBW Research, of course, which has correctly predicted all interest rate decisions since the first hike in 2022! 🎯

As expected: ECB is adopting a wait-and-see approach

Central bankers versus investors

But this time the prediction was really easy. Lagarde and Co. used the interview-hungry media at the World Economic Forum in Davos last week to remind us of their rather hawkish positions. The governor of the Austrian central bank even said that he did not yet consider any interest rate cut to be a foregone conclusion this year. This stark statement seems to have overshot the mark and does not appear to be shared by any of his colleagues. But the ECB representatives were consistent in their attempts to curb rate cut fantasies among investors. ECB chief Christine Lagarde even mentioned a possible date: she believes a first rate cut is likely in June. This has also been our view for months.

Clear words were already spoken in Davos

Fear of second-round effects

Inflation rates in the eurozone fell significantly last year – to below 3% in the last quarter. However, this is not enough for the ECB to go soft. Firstly, the monetary authorities point to the fact that it was primarily the so-called base effects in energy that caused inflation to fall. In other words, the high energy prices of the previous year have normalized and dampened inflation. This has little to do with the effect of monetary policy and was a one-off effect. Rather, concerns have grown that logistics chains could come under pressure again in the long term. For example, due to the terrorism of the Yemeni Houthis, which leads to maritime traffic being diverted from the Suez Canal, putting renewed stresses on supply chains. The price for a 40-foot container from Asia to Europe has already quadrupled.

Secondly, the ECB fears so-called second-round effects. This is based on the expectation that employees will fight for wage hikes to compensate for the loss of real income caused by the inflation episode. This is not only understandable, but also likely to succeed given the tight labor market in much of the euro area. The ECB first wants to see whether such an inflation-perpetuating price-wage spiral is set in motion. In June, the central bankers believe they will know enough to act.

Growing fear of a price-wage spiral

Is ECB too hesitant to cut interest rates?

Portuguese Governor Mário Centeno was the lone ECB voice in Davos for a swifter cut. And there are arguments for this. We measure inflation over the course of a full year. However, if inflation falls continuously throughout the year (as in 2023), the "expensive" months that occurred a long time ago dilute the current "cheaper" months. This may exaggerate current inflation. If we only consider the price increases of the last six months and extrapolate to a full year, then inflation in December was almost exactly at the of 2% target. If we look no further back than three months, the annualized rate shows deflation (see chart). Shouldn't the ECB therefore cut interest rates now? If only it were that simple. Such short-term behavior would make monetary policy much more volatile. And an erratic interest rate policy in times of heightened uncertainty would entail considerable risks, including to the stability of inflation expectations. Confusing? Yes, of course. Monetary policy is complicated and multidimensional. Even if yesterday seemed boring: it remains exciting.

Annualized inflation* rate over the last 12, 6 and 3 months

Source: ECB, LBBW Research.
*HCPI euro area, seasonally adjusted.
The black line is the standard inflation definition.

Disclaimer:

This publication is addressed exclusively at recipients in the EU, Switzerland, Liechtenstein and the United Kingdom.

This report is not being distributed by LBBW to any person in the United States and LBBW does not intend to solicit any person in the United States.

LBBW is under the supervision of the European Central Bank (ECB), Sonnemannstraße 22, 60314 Frankfurt/Main (Germany) and the German Federal Financial Supervisory Authority (BaFin), Graurheindorfer Str. 108, 53117 Bonn (Germany) / Marie-Curie-Str. 24-28, 60439 Frankfurt/Main (Germany).

This publication is based on generally available sources which we are not able to verify but which we believe to be reliable. Nevertheless, we assume no liability for the accuracy and completeness of this publication. It conveys our non-binding opinion of the market and the products at the time of the editorial deadline, irrespective of any own holdings in these products. This publication does not replace individual advice. It serves only for informational purposes and should not be seen as an offer or request for a purchase or sale. For additional, more timely in-formation on concrete investment options and for individual investment advice, please contact your investment advisor.

We retain the right to change the opinions expressed herein at any time and without prior notice. Moreover, we retain the right not to update this information or to stop such updates entirely without prior notice.

Past performance, simulations and forecasts shown or described in this publication do not constitute a reliable indicator of future performance.

The acceptance of provided research services by a securities services company can qualify as a benefit in supervisory law terms. In these cases LBBW assumes that the benefit is intended to improve the quality of the relevant service for the customer of the benefit recipient.

Additional Disclaimer for recipients in the United Kingdom: Authorised and regulated by the European Central Bank (ECB), Sonnemannstraße 22, 60314 Frankfurt/Main (Germany) and the German Federal Financial Supervisory Authority (BaFin), Graurheindorfer Str. 108, 53117 Bonn (Germany) / Marie-Curie-Str. 24-28, 60439 Frankfurt/Main (Germany). Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.