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The view from the interest rate summit

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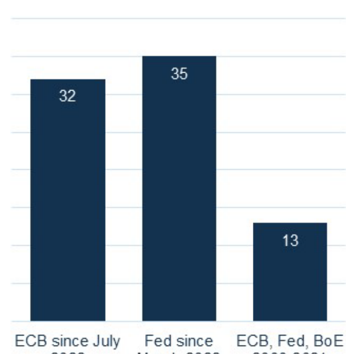
The ECB is done with its hiking trip

The interest rate thriller is over for now. Christine Lagarde and her team have made one last readjustment. Another 25 basis points now bring the deposit rate to 4%. The rate decision was in line with the expectation of LBBW research, while the capital market saw the probability of a hike at fifty-fifty. We interrupt the program for this short commercial break: LBBW Research has been ranked No. 1 among 20 banks by Reuters in terms of precision of ECB forecasts.

The hiking campaign was short and sharp, now it is over

It was only a little more than a year ago, at the end of July, that the deposit rate was still negative, at -0.5 %. Calculated in a different way: since the summer of 2022 ECB has increased interest rates by an average of 0.32 percentage points per month. Almost three times as fast as the previous rate hike campaigns by ECB, Fed and Bank of England since 2000 (see chart). Respect: that’s what resolute action looks like.

Average interest rate increases per month between first and last increase (in basis points)



Source: LBBW Research

Sure, admittedly the ECB was a little tardy in getting into gear. But would the European inflation trend really have turned out markedly different if Frankfurt had first hiked already in March 2022, as the Fed did, instead of at the end of July? I very much doubt it.

An overcast view from the summit

But let's not go there. Looking in the rearview mirror is something for economic historians. What does the view forward look like from the interest rate peak that we have now climbed? Meteorologically I would say: very cloudy, but every now and then a few rays of sunshine flash through.

At the end of the day, the main question is whether the interest rate truncheon will be big enough to thrash inflation, that "greedy beast", as Bundesbank President Nagel called it last week.

Some observations give reason for hope. These are the rays of sunshine visible from the peak.

Compared with the peak of inflation in October 2022, the rate of price increases in the euro zone has been cut by half to 5.3% in August. Due to base effects – last year in the fall energy prices were at their stratospheric highs – I expect inflation to ease further in the coming months.

Forward-looking measures of inflation such as the import, producer and wholesale price indices are in some cases already back in deflationary territory. Sooner or later this should also be reflected in inflation for us consumers. So, can the ECB relax?

The beast has not yet been defeated

Far from it! Now to the heavy cloud cover. What is rightly raising worry lines on Lagarde's forehead is the persistence of the so-called core inflation rate (excluding the volatile components energy and food). The core rate has barely budged since the beginning of the year (also 5.3% in August). Despite the ever-weakening euro area economy the labor market is still going strong. Recession at full employment! This unusual combination weakens the impact monetary tightening has on prices, because wage pressures remain elevated.

Core inflation has hardly moved this year

It may therefore take longer for inflation to return to the 2% target. At LBBW Research, we assume that this will be the case in 2025. That's also the view of the ECB, as it reiterated yesterday.

But the risk of inflation remaining higher for even longer is rising. That is why we recently increased the probability of our corresponding scenario to 20%. Should this scenario come to pass, the ECB will probably have to tighten again. In that case, the interest rate peak would not even have been reached yesterday. There may yet be a sequel to the thriller in Frankfurt's East End!

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